PALLAS
CAPITAL ADVISORS

PCA Quarterly Commentary

Q2 2020

The second quarter of 2020 witnessed a V-shaped recovery for equity markets, while the Main Street economy demonstrated incremental signs of recovery from a deep trough. The country saw an accelerated amount of coronavirus cases in the sun belt states, as local economies attempted to balance business reopening's with the citizens' health. The Pallas Capital Advisors Q2 report examines the disconnect between the Wall Street recovery and the Main Street economy, while also discussing trends in portfolios and outlook for the balance of 2020.

Global Markets Summary

	S&P 500	NASDAQ	Russell 2000	MSCI World Ex US	MSCI Emerging Markets	Barclays US Aggregate Bond	Barclays US High Yield Bond
Q2 2020	20.5%	30.9%	25.4%	15.6%	18.1%	2.9%	10.2%
YTD 2020	-3.1%	12.7%	-13.0%	-11.2%	-9.8%	6.1%	-3.8%

SOURCE: Morningstar, MSCI, Bloomberg, NASDAQ

Equity markets rallied strongly in the second quarter. While the pandemic induced recession is very deep, incremental news during the quarter was positive driving markets higher. Progress was made on treatments and vaccines for Covid-19, economies started to open up, unemployment began to come down, and retail sales rose from the depths. As shown in the table above, a wide dispersion of returns was seen in equity markets for the year. NASDAQ is up 12.7% YTD while the Russell 2000 is down 13.0%. The NASDAQ is a technology driven index while the Russell 2000 is more heavily weighted towards financials and industrial companies. Another example of technology driving the market is in the S&P 500. The top five stocks in the S&P 500 (Apple, Microsoft, Amazon, Alphabet/Google and Facebook) represent over 20% of the index and are up an average of 24% as of 6/30/2020. These beneficiaries of the work from home/connected world have been responsible for keeping the S&P500 only down 3% for the year.

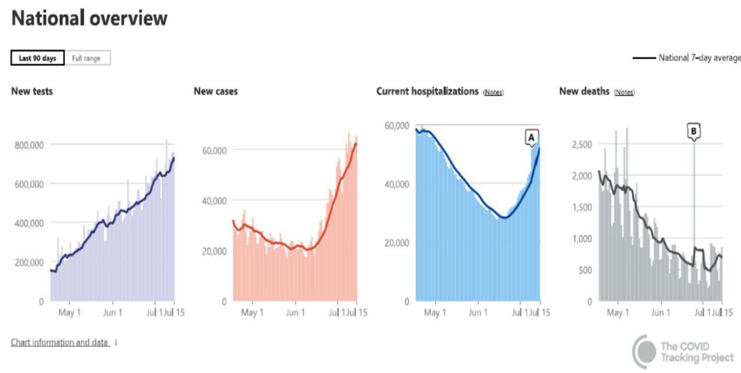
An interesting dichotomy has been the differential in the V-shaped recovery of the stock market, and the slow U-shaped recovery in the economy. One measure of the economic impact is the forward earnings estimates of the S&P 500 companies. For 2021 (recovery year), earnings estimates have been cut by 17% since the beginning of the year, per Factset. With the recovery in market and cut to earnings, the forward P/E for the S&P500 has risen from 14x's in March to 19x's at the end of June. Given the rise in valuations, expectations for rapid recovery in the Main Street economy appear to be high.

Fixed Income markets have rallied by 6.1% YTD and 2.9% QTD, as measured by the Bloomberg Barclays US Aggregate Bond Index. Long term treasury bonds have performed very well as interest rates have fallen. The 30 year yield has dropped from 2.4% at the end of the year to 1.4% at the end of June driving the price of these bonds up over 20%. Corporate high yield bonds have performed in the opposite direction. YTD high yield is down 3.8% given the pressure these companies face from the recession. The category did rally by 10% in Q2, and the outlook will be tied to the pace of the economic recovery.

Commodities have demonstrated a wide dispersion in returns as evidenced by the rally in gold and the crash in oil prices. Gold prices typically rally in uncertain times as a safe-haven asset. Gold can also serve as an inflation hedge. As governments around the world are increasing fiscal deficits and easing monetary policy, inflation could be a result which could drive the gold price higher. Oil has faced a perfect storm this year with the physical economy almost completely shutting down, while earlier in the year OPEC increased supply. While OPEC has eased off the aggressive stance, the depression in global activity (airline travel, shipping, commuting, etc) has left the spot oil price down 35% through 6/30/2020. The near term WTI contract also dipped below zero in April due to an imbalance in futures contracts versus the ability to accept physical delivery.

Economic Trends

The coronavirus pandemic continues to be the largest macroeconomic driver as the pace of the economic recovery will be determined by how quickly the US can safely get back to normal activity. Q2 began with a steady improvement on every relevant metric. Additional positive news included many private companies (Pfizer, Moderna, Regeneron, etc.) announcing progress on treatments and/or vaccines for coronavirus during the quarter.



SOURCE: The Covid Tracking Project

SOURCE: Factset

In June, a significant change in trend happened to active new cases of covid-19. The sunbelt states, where economies had first opened up, saw a dramatic spike in cases. Current cases in the US are exceeding those of March and April. Hospitalizations and new deaths have increased but not at nearly the same pace as cases. Testing is up 3-4x's versus April, with probable cases (in addition to confirmed cases) now being included in the total count. Hospitalizations are likely not as severe because the age range of the newly infected is skewing younger. While states struggle to get a handle on current cases, many questions are still unanswered regarding schools reopening in the fall, affecting millions of families.

The scale of the economic impact is unparalleled since the great depression. The current unemployment rate of 11.1%, while down from the peak, still exceeds levels since at least 1948.

SOURCE: fred.stlouisfed.org

Incremental improvement in the economy has been seen on many fronts – initial unemployment claims have been reduced, retail sales have increased sequentially, global purchasing managers indices have improved. However, the level of activity in the economy is still far below potential. The federal government has had a strong response on the fiscal and monetary front. The increase in government subsidies has certainly aided consumers in the short run. Congress is currently debating yet another stimulus package. At some point, the stimulus will run out, and if economies are not fully open, the US could slide deeper into the recession. State budgets are also under tremendous pressure which could lead to an increase in local taxes.

Pallas Capital Advisors Portfolios

Pallas Capital client portfolios in Q2 rallied along with markets. From an asset allocation perspective, portfolios were positioned conservatively at the beginning of the quarter given the global pandemic and subsequent economic impact. A higher than normal level of cash was raised to reflect this caution. The higher cash positions were a drag on performance relative to typical asset allocations in the Q2 rally. Pallas Capital began dollar cost averaging by adding back to risk assets in April and May as the news improved around treatments for the coronavirus and economies began their opening process.

Pallas Capital equity philosophy is to own high-quality companies with strong balance sheets, solid growth prospects and sustainable competitive advantages. Sectors demonstrating this best in the market today are technology and healthcare, where the portfolios are overweight. This positioning has led to strong performance versus benchmarks on a YTD basis. As the recovery begins, Pallas Capital is looking for opportunities in industries that are likely to rebound while avoiding industries permanently scarred by the pandemic. Industries likely to recover faster would be healthcare tied to elective surgeries, cyclical technology such as semiconductors, and consumer stocks like homebuilding where interest rates are low, and consumers may seek to leave cities. Industries and companies to avoid would include cruise lines and companies with poor balance sheets as the length of the downturn could materially negatively affect outcomes.

Fixed Income Treasury markets have rallied on the decline in long term yields. High grade corporate, municipal and short-term debt have lagged this rally but are still up in the absolute. High yield debt and many structured products, such as CLOs, are down for the year. Pallas Capital has been positioned in shorter duration, high quality debt and thus has performed well in absolute returns on the year. With the drop in market yields, Pallas Capital has sought to maintain previous levels of income streams. The portfolios have rotated some government debt into short-term, high-grade corporates to increase yield while maintaining quality investment grade exposure.

Outlook

As 2020 unfolds, Pallas Capital will continue to monitor medical progress of the coronavirus as well as the pace of recovery in economic activity. Coronavirus active cases are spiking, while hospitalizations and death rate are not as severe given the younger patient set. Progress has been made on treatments and vaccines, but continued infections will slow the recovery.

Wall Street has demonstrated a V-recovery while the Main Street economy continues to struggle with high unemployment and restricted economic activity. Pallas Capital looks to differentiate between industries that have been permanently scarred by the pandemic versus those that should recover as activity picks up. US earnings season begins mid-July where the market will be able to judge whether the rally in markets will be justified by solid earnings reports. Or, poor earnings reports relative to expectations could drive the market lower.

Pallas Capital continues to have a cautious asset allocation recommendation given the risks to the economy and recovery in markets that has already taken place. Developments on the medical front, company earnings reports, and government stimulus and taxation headlines will be key variables tracked going forward.

Sincerely,

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Chief Investment Officer
Pallas Capital Advisors