PALLAS
CAPITAL ADVISORS

PCA Monthly Commentary

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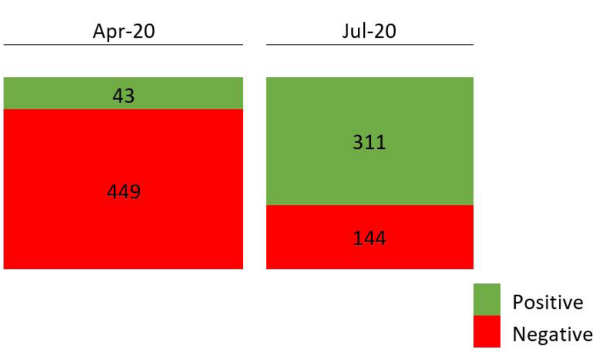
The Market Recovery Continues with Earnings Better Than Feared

Global equity markets continued to rally in July with the S&P 500 +5.6%, NASDAQ +6.0%, EAFE +2.0%, and Emerging Markets +8.2%. Fixed income performance was also in positive territory with the Bloomberg Barclays US Aggregate up 1.5% and US High Yield rising 4.7%. Commodities joined the rally as symbolized by gold rallying 11% on the month. While COVID-19 had a resurgence in the sunbelt states, and Congress debated a new fiscal stimulus bill, US companies reported strong earnings versus expectations, setting the stage for the continued rally.

July earnings season better than expected

Concerns around Q2 earnings were high given the scale of the economic impact from the pandemic. S&P 500 estimates had already been slashed during calendar Q2. With unemployment running north of 11%, expectations were low for companies exceeding earnings. However, with the majority of companies reporting, positive upgrades have vastly exceeded downgrades for the market as a whole. 311 companies had upward revisions versus 144 with downgrades.

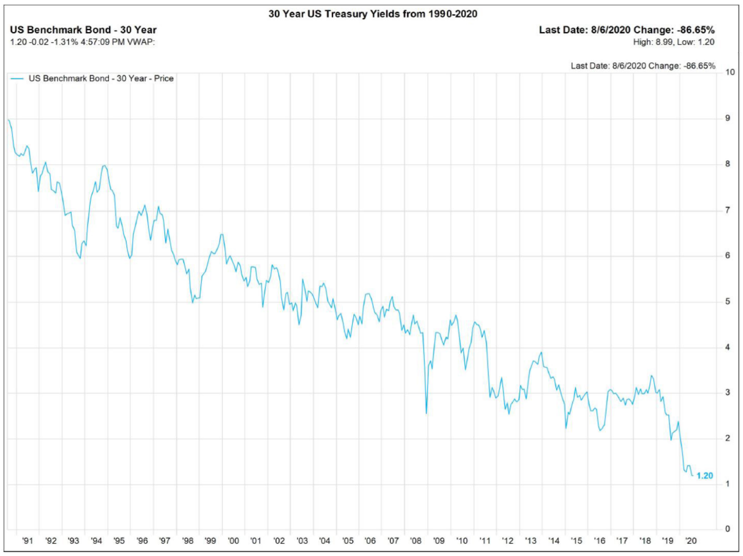


Source: Pallas Capital Advisors, Factset

Generally, technology sectors led the way as the economic shift to digitization continued at an accelerated pace, benefitting earnings. The strength was also broad-based within other sectors participating like household products, home building, and pharmaceuticals. Weakness is still evident in cruise lines and mall operators. As global equity markets moved higher over the past few months, Pallas Capital questioned whether earnings would confirm this trend. For July, positive earnings revisions supported the rise in equities.

Impact of low risk-free rates

Global risk-free rates have been in a downtrend for decades driven by lower real growth, lower inflation, and demand for safe and liquid assets. The 30 year US Treasury has dropped to 1.2% as of the beginning of August.



Source: Pallas Capital Advisors, Factset

Low risk-free rates have implications across asset classes. One significant impact is on the valuation of risk assets. If the 1.2% coupon is viewed as cash flows in perpetuity, the implied P/E of that risk-free stream of cash flows is over 80x's. In comparison, the S&P 500 has a dividend yield of 1.75% and a P/E in 2021 of 20x's. Clearly, risk exists in S&P 500 earnings, and yet the market cap weighting skews towards technology and healthcare companies where futures earnings streams are more likely to be achieved. The valuation of an asset class such as equities incorporates the risk-free rate. The lower the risk-free rate, all else equal, the higher the warranted P/E on equities.

Another implication of low rates can be seen in commodities and currencies. As US interest rates fall, budget deficits expand, and trade deficits remain, the US dollar will weaken against other developed market currencies such as the Euro. Commodities also benefit from similar drivers. Gold is up 11% in July alone due to these trends. While the US dollar has experienced some short term cyclical weakness, a secular downtrend is not predicted due to stronger relative growth rates, interest rates, and reserve currency status.

Fiscal stimulus - What are next steps?

Congress is currently still debating the next fiscal stimulus package. While corporate earnings have been better than expected, a question remains as to how much fiscal stimulus has supported these earnings.

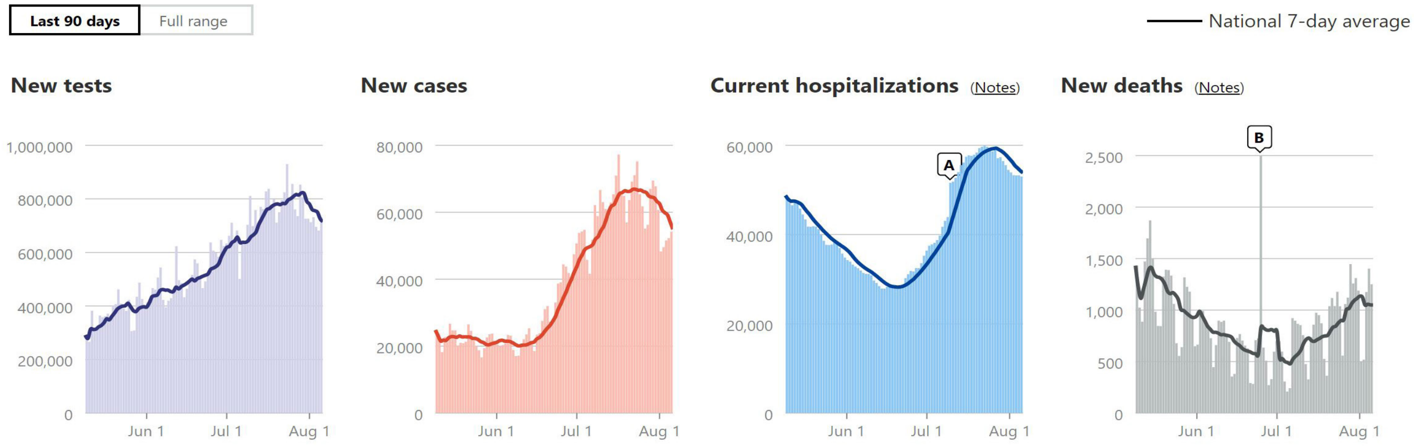
Direct stimulus checks and weekly unemployment benefits of $600 certainly helped support consumer spending. The timing and level of reduction to the fiscal stimulus poses risk to the underlying economy and markets.

With many state economies still only partially open, some type of package is needed to support spending. In addition to the fiscal stimulus risk, other risks from the government standpoint are the upcoming election and potential tax increases at the federal and state level.

Pandemic tracking

All the discussion around markets and the economy comes back to progress on the coronavirus pandemic. The spike seen in sunbelt states appears to be easing off as daily new active cases and hospitalizations have inflected downward.

Progress continues to be made on treatments and vaccines as some larger-scale vaccine studies are underway. A crucial test will be as schools open in the fall. The volatility around schools potentially stopping and starting adds risk to market sentiment.



Source: www.covidtracking.com/data

Conclusion

July was another positive month across all asset classes. Corporate earnings came in much better than expected which marks a positive inflection point from the pandemic downgrades. Valuations of risk assets need to be viewed in relation to current risk-free rates. With this lens, valuations of risk assets may not be as expensive as they first appear.   Even with positive news on corporate earnings, significant risks remain around fiscal stimulus, the election, and the economic impact of COVID-19.