PALLAS
CAPITAL ADVISORS

PCA Monthly Commentary

September 2020

Technology Drives Equity Indices Higher Again

Driven by technology stocks, global equity markets extended the rally in August with the S&P 500 +7.2%, NASDAQ +9.7%, EAFE +4.9% and Emerging Markets +2.1%. Fixed income performance was mixed with the Bloomberg Barclays US Aggregate -0.81%, as long-term rates edged up. US high yield improved by 1.0%. Commodities diverged with gold down 0.5%, and oil rallied up 6.3%. Macroeconomic data provided fodder for bulls and bears. Questions remain on the pandemic, potential fiscal stimulus packages, and election scenarios.

RECORD Q2 EARNINGS BEATS

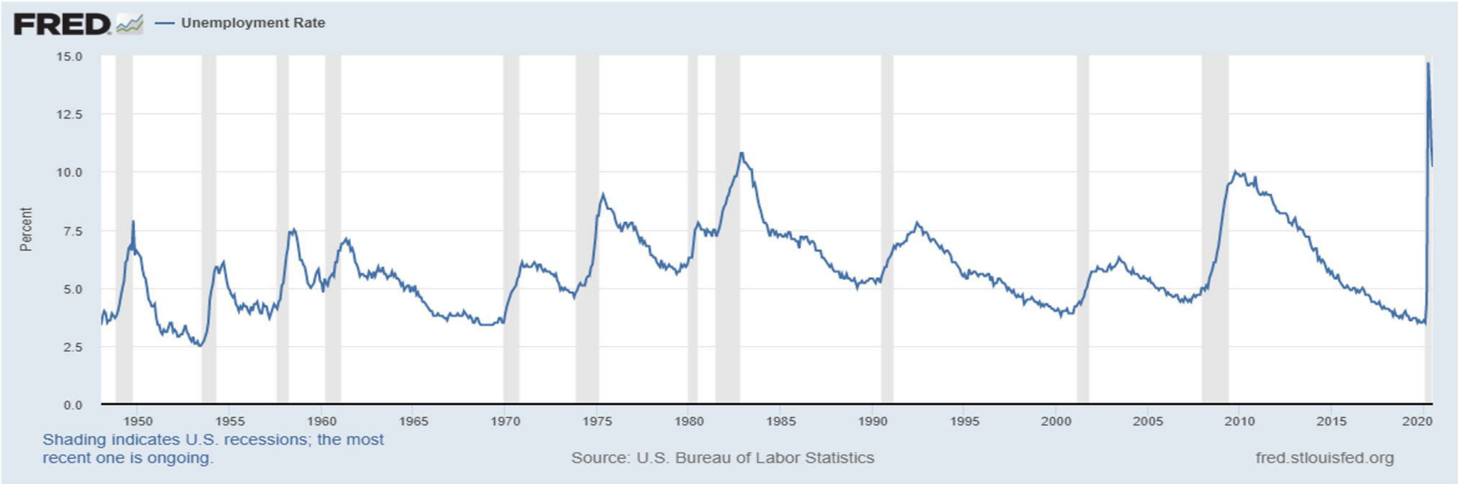
The pandemic caused S&P500 earnings estimates to be lowered by 28% from the beginning of 2020 through June (per Factset). Expectations were quite low coming into Q2 given the scale of the economic impact from the pandemic. However, S&P 500 companies proved significantly more resilient than anticipated. Aggregate Q2 earnings came in 23.1% above expectations versus a typical 4.7% surprise rate.

The sectors driving the surprise included technology, healthcare and industrials. Companies such as Amazon, Salesforce, UPS, and Home Depot all had earnings exceed expectations. Stock performance followed the earnings surprises with remote technology, transportation, software, and home improvement companies leading the market higher. Weakness was evident in commercial real estate and apparel retail. Estimates for 2021 are still down 15% from the beginning of 2020. However, a positive inflection in corporate earnings is evident. A sustained recovery in earnings would support the rally in equity markets.

Source: Pallas Capital Advisors, Factset

MACROECONOMIC TRENDS ARE MIXED

The stock market recovery has been swift but what are underlying economic indicators signaling? The level of unemployment affecting families is still quite high by any measure. Initial unemployment claims are still around 1 million a week. Continuing claims are running at 14.5 million. The overall unemployment rate is 10.2%.



Source: Pallas Capital Advisors, fred.stlouisfed.org

The level of unemployment evident in the economy would typically signal a severe recession with resultant negative impacts on markets, consumer spending, and so on. However, contrasting against the unemployment level, durable goods have bounced back, and the Citigroup Economic Surprise Index has rebounded to very positive territory in August. Consumer spending has rebounded to pre-pandemic levels.

Source: Pallas Capital Advisors, fred.stlouisfed.org

Contrasting the recovery in retail sales in 2020 with the financial crisis of 2008: due to the excess of financial leverage in the 2008 crisis, retail sales took five years to recover to pre-crisis levels, while the 2020 recovery demonstrates a different crisis this time. The government-induced shutdown to protect public health can mean that the underlying economy does not have an imbalance that needs to be worked through for a swift recovery. If progress can be made on Covid-19, spending can be sustained at the recovery level. The risk to these positive sales figures is the massive fiscal stimulus that has been pumped into the economy. As these transfer payments fade, spending may fade as well.

FISCAL STIMULUS EXPIRATION AND THE ELECTION

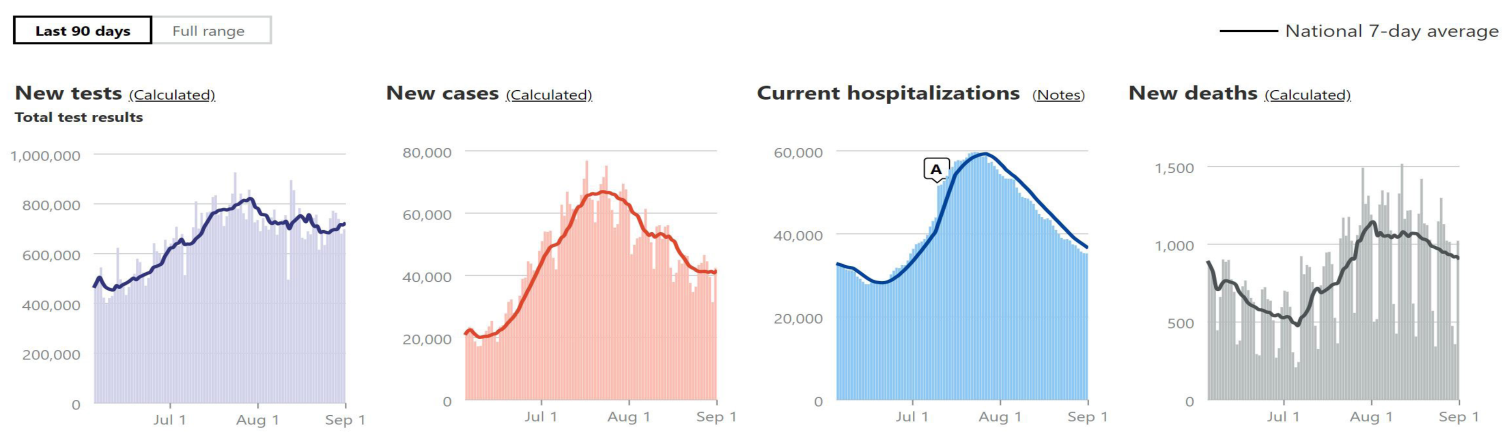
Congress is currently still debating the next fiscal stimulus package. The supplemental unemployment payments have ended which could impact August consumer spending. Congress may yet pass a new bill, especially for optics ahead of the election. However, any new spending will likely be much lower than previous packages. An air pocket in spending could occur as stimulus fades and unemployment remains high.

The November Presidential election is coming into focus with both parties hosting their respective conventions this month. Taxes are likely headed higher regardless of which party wins given the scale of fiscal spending. A Democratic sweep of the Presidency, Senate, and House would likely lead to higher taxes across corporations and individuals. Elections typically have limited impact on markets in the long run. The uncertainty that stirs ahead of elections clears post-election and allows for markets to get back to valuing earnings and economic activity. A risk for this election could lie in any contested results. Any extended contested result process could lead to a short-term risk off environment.

PANDEMIC TRACKING – TRENDING POSITIVE

Daily active coronavirus cases and hospitalizations extended their downward trend this month. Even with news stories regarding college openings and outbreaks, the overall numbers demonstrate improvement. K-12 schools are just beginning to open with varying procedures around the country ranging from remote, to hybrid, to in-person. Impact from these opening will be watched closely for any other outbreaks.

Progress continues to be made on treatments and vaccines. The Milken Institute tracks the various coronavirus initiatives around the world. Currently, 316 treatments and 207 vaccines are under development. Testing advances are also happening with a rapid pace. Abbott Labs and Roche announced this month the development of a 15 minute Covid test. Abbott expects to be able to produce 50 million tests a month in October. Fast, accurate, inexpensive testing will be a key pillar to fully reopening the economy. The discussions surrounding the markets and the economy all come back to progress on the coronavirus pandemic, where hopeful developments were evident in August.



Source: covidtracking.com/data

CONCLUSION

August was another positive month for risk assets. Q2 corporate earnings came in much better than expected which marks a positive inflection point from the pandemic downgrades. Technology stocks led the way for earnings growth and stock performance. Macroeconomic data is mixed as US retail sales have fully recovered while unemployment remains at record levels. Focus is turning towards Washington for both further fiscal stimulus and the election. Coronavirus news flow remains positive with reductions in cases and advances in testing and vaccines. Pallas Capital Advisors continues to look at a balanced asset allocation stance for clients, reflecting the overall risks and opportunities in the market.