PALLAS
CAPITAL ADVISORS

# PCA Quarterly Commentary

**Q3 2020**

Global markets rallied across the board in the third quarter of 2020. The coronavirus refuses to go away and even infected the President of the United States. The U.S. economy continues to produce mixed results. The U.S. election is coming into focus with implications for markets, taxes, and the economy.

## 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 |
|---|---|---|---|---|---|---|---|
| Q3 2020 | 8.9% | 11.2% | 4.9% | 8.1% | 9.7% | 0.6% | 4.6% |
| YTD 2020 | 5.6% | 25.3% | -8.7% | 2.1% | -0.9% | 6.8% | 0.6% |

SOURCE: Morningstar, MSCI, Bloomberg, YCharts

Equity markets rallied in the third quarter. Technology stocks led the way again with NASDAQ up 11.2% for the quarter. S&P 500 (+8.9%) and Russell 2000 (+4.9%) were positive but lagged NASDAQ returns. Traditional cyclical's – industrials, financials, energy, and materials – make up a much larger percentage of the S&P and Russell vs the NASDAQ. Corporate earnings trends broadly supported the rally as second-quarter earnings came in better than expected. Estimates had been cut during the early stages of the pandemic, but many sectors have been able to recover faster than anticipated. Stay-at-home technology names beat earnings but some consumer cyclical names also surprised to the upside. Bricks and mortar retailers, commercial real estate, and travel all had earnings worse than expected. The beneficiaries of the work from home and connected world have continued to do well which has driven both earnings and markets up for the quarter.

Fixed income markets in Q3 also rallied with a 0.6% gain for investment-grade bonds (Bloomberg Barclays Aggregate) and 4.6% gain for high yield bonds (Bloomberg Barclays High Yield). The U.S. yield curve was little changed on the quarter and thus the muted performance for investment grade.

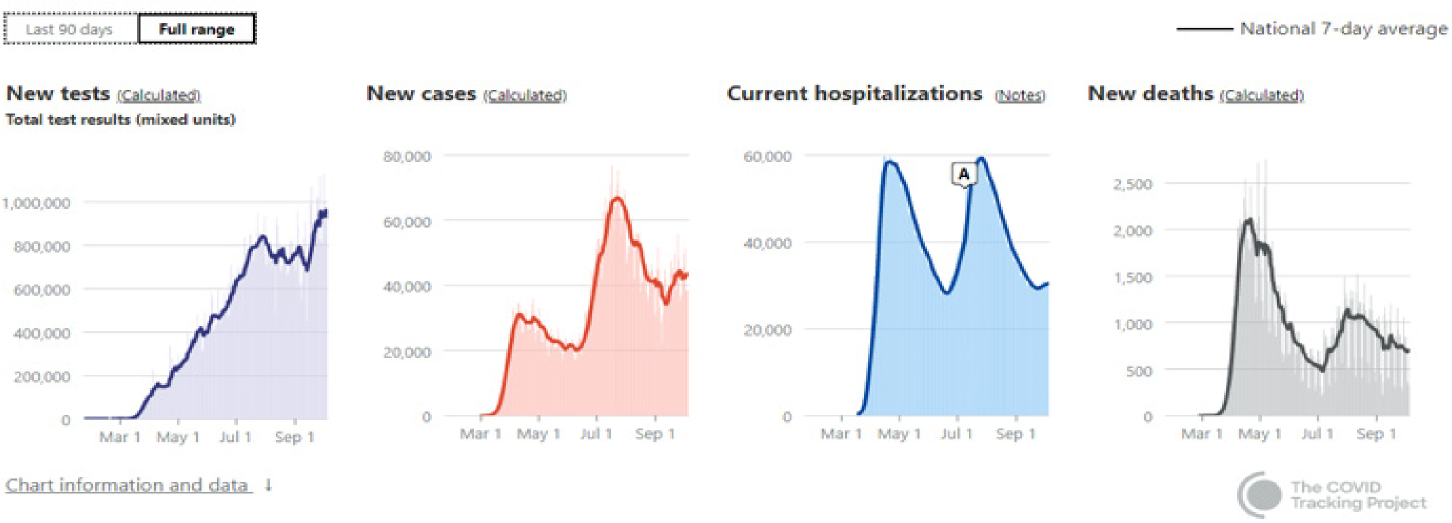
High yield performance was stronger, as corporate earnings came in better than expected, and liquidity in the market searched out higher absolute yields. During the quarter, Federal Reserve Chairman, Jerome Powell, signaled a change in the Fed's inflation targeting policy. Rather than targeting a specific level of inflation (2.0%), the Fed will now target an average of 2.0% over time. The implication being that the Fed will likely keep rates lower for longer to ensure that inflation is sustainable at the target level. If inflation were to run too high, the Fed has the tools to react by hiking rates.

Commodity prices demonstrated less volatility in Q3 versus Q2. Gold prices marched up again by 6.7% bringing the YTD gain to 24.5%. Oil prices (West Texas Intermediate) settled down for an erally flat Q3 after a plunge of 35% YTD. Commodities prices historically have acted as a hedge against unexpected inflation. While the Fed is poised to keep rates lower for longer, the large amount of fiscal and monetary stimulus could lead to inflation down the road and put upward pressure on commodity prices. On the negative side, continued economic weakness would put downward pressure on prices due to the lack of incremental demand.

# Economic Trends

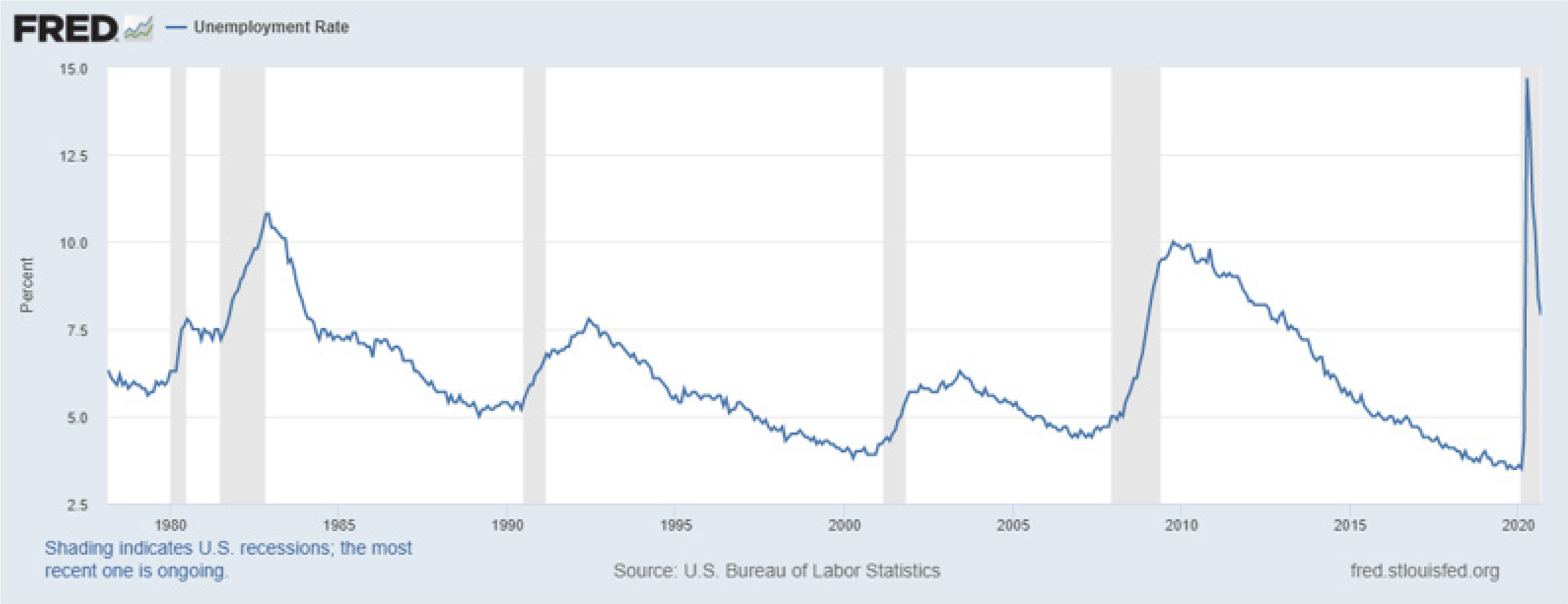
The pandemic continues to be the largest macroeconomic driver as the pace of the economic recovery will be determined by how quickly the U.S. can safely get back to normal activity. Q3 began with a spike in active cases in primarily Sunbelt states where social distancing guidance had been relaxed.  Affected states reacted by reinstating social distancing and mask requirements. Testing capacity has been significantly increased providing better information for healthcare providers.  Improvement in cases followed throughout the summer, but the country has leveled off around 40,000 new cases a day as schools have begun to open up.

During this resurgence, hospitalization and death rates have improved materially from the beginning of the pandemic.  As an example, the President of the United States, Donald Trump, developed the disease and reportedly was treated with a mixture of therapies.  While treatment protocols have improved, the country awaits a viable vaccine.  Vaccine distribution at scale will most likely not happen until 2021.




SOURCE: Morningstar, MSCI, Bloomberg, YCharts

While the coronavirus maintains a presence in society, the economic impact has been dramatic.  A dichotomy has developed with winners and losers among industries.  Unemployment stands at 7.9% which is still near other recession peaks.  Some of the hardest-hit industries include travel, leisure, restaurants, and gymnasiums.  The economy will not be back to full strength until coronavirus restrictions are lifted to allow for these industries to recover.



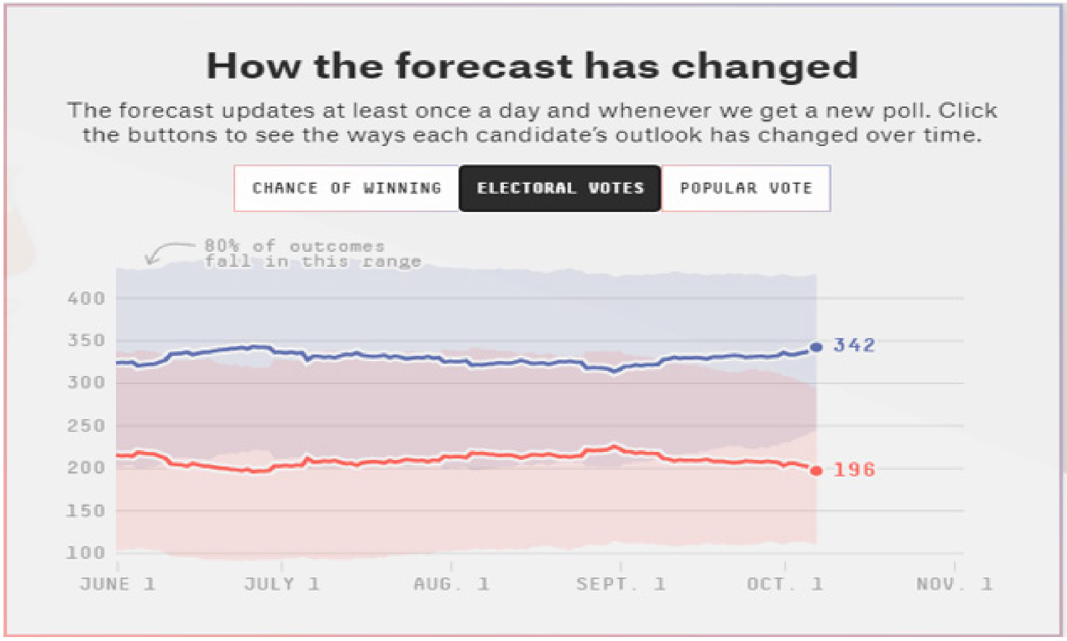

SOURCE: fred.stlouisfed.org

Despite the recession level unemployment, retail sales have rebounded to pre-pandemic levels. Consumers at a macro level have restored spending faster than any recent recession. Beneficiaries include work from home industries, technology spend, online shopping, and home improvement while travel and leisure spend is down significantly. Government fiscal stimulus has contributed to this spending through supplemental unemployment payments, stimulus checks, payroll protection programs, etc. A question remains around how much this spending could fall as stimulus programs fade. The contentious tone in Washington has prevented any further stimulus packages as of this writing. State budgets are also feeling the pressure which could result in more job losses or tax increases.


SOURCE: fred.stlouisfed.org

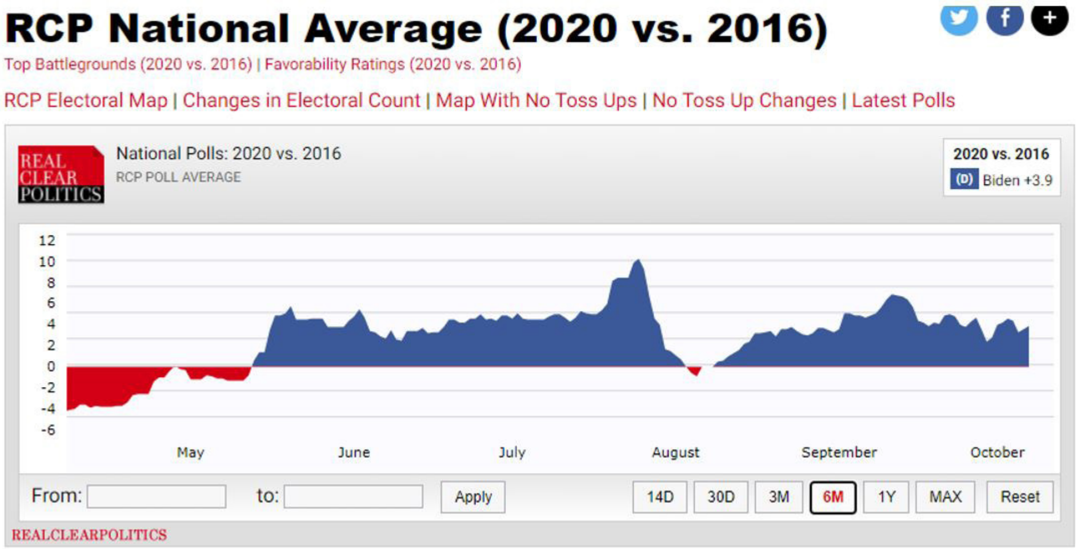
## U.S. Election to the Forefront

The U.S. Presidential debate puts the election into focus. A raucous debate may not have changed many voters' minds, but poll numbers post-debate have drifted up in Joe Biden's favor continuing the improvement from the beginning of September. Polls show an 84% chance of a Biden victory and a forecasted 342 electoral votes.



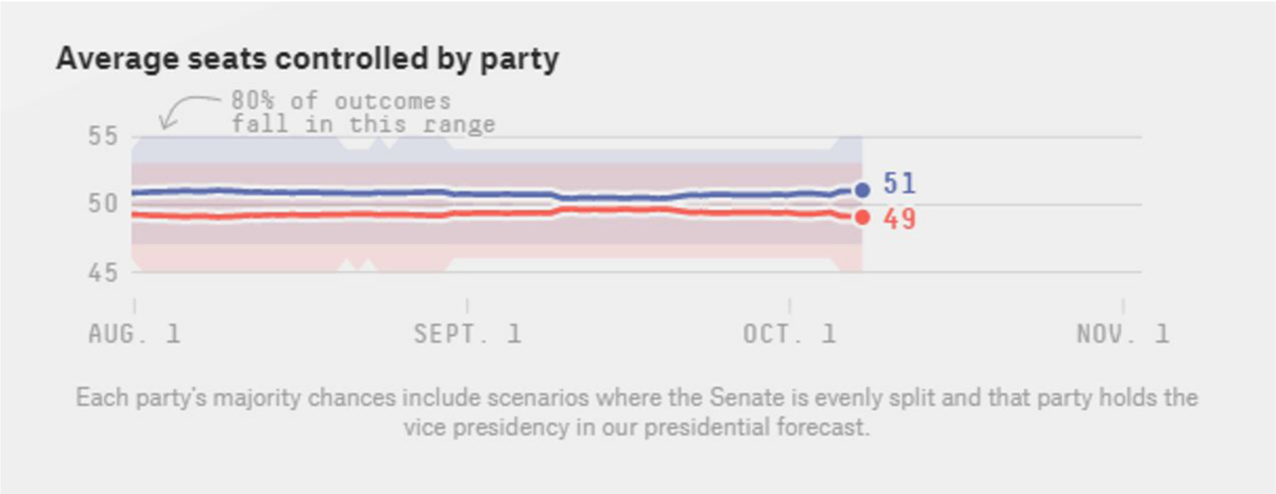

SOURCE: www.projects.fivethirtyeight.com/2020-election-forecast/

While Joe Biden may lead in the polls today, Hillary Clinton also led in the polls in 2016. However, she ultimately ended up losing the election to Donald Trump. The difference this year is that Biden's lead is almost 4 points wider than Clinton's in 2016 (Source:RealClearPolitics). Even accounting for margins of error in polls, Biden is in a much stronger position. Turnout for the Democrats in 2016 was also lower than expected as a Clinton win seemed imminent. The general view this year from the Democratic side is to not take any lead for granted. We will know the predictive powers of these polls come November.




SOURCE: www.realclearpolitics.com/epolls/2020/president/us/trump-vs-biden-national-polls-2020-vs-2016/

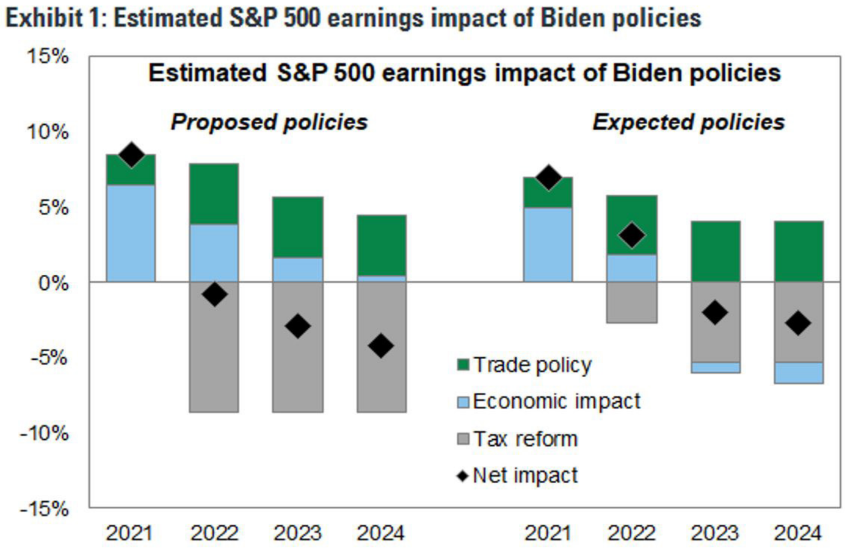
The control of the U.S. Senate is also up for grabs in this election. The last two years of the Trump Presidency experienced a Republican Senate and Democratic House. As such, gridlock has ruled much of the last two years. The most recent evidence being the failed additional round of fiscal stimulus funds for the economy. The Democrats are currently favored to win the Senate in this election. Projections from FiveThirtyEight show the Democrats gaining a slim 51 to 49 advantage.




SOURCE: www.projects.fivethirtyeight.com/2020-election-forecast/

## Implications of a Democratic Sweep

If current polls hold, the Democrats will gain control of Washington by ruling the Presidency, the Senate, and the House. With any divided government, the odds of any material legislation being passed would be low. However, with the Democrats in control, the runway would be open for change. The Biden tax plan, if implemented as stated, would drive up taxes on corporations and individuals, but could be scaled down. Potential offsets to this could include a stimulative infrastructure spending and lower tariffs. Goldman Sachs estimates in the chart below show the impact to S&P 500 earnings with their estimates of a Biden tax plan, fiscal stimulus, and tariff reductions.

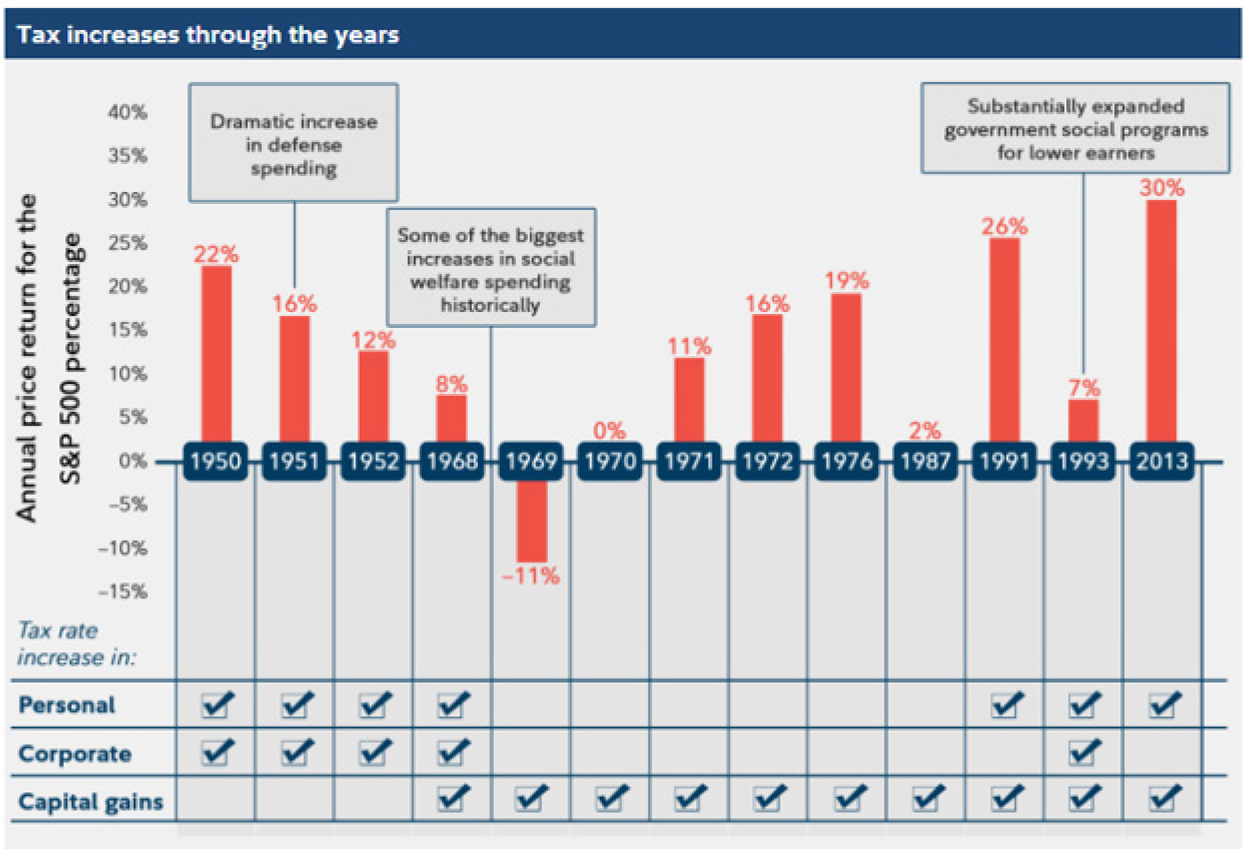



SOURCE: Goldman Sachs Global Investment Research

Under Biden's proposed policies, earnings would increase in 2021 and then fall less than 5% through 2024. If Biden's tax plan is watered down at all, Goldman estimates that S&P earnings would grow in 2021 and 2022 while falling less than 5% in 2023 and 2024. The Goldman case is one point of view. When assessing any earnings impact from a new government, a wide range of scenarios is possible.

## Stock Market Implications

Pallas Capital has analyzed past elections for its impact on equity markets from various angles. Most studies focused on long-run returns pointing to markets being higher post Presidential elections. Generally, uncertainty ahead of elections gives way to certainty of policy post-election, where earnings growth of companies tends to drive markets higher. The graphic below depicts the year of tax rate increase and the subsequent market returns. In the majority of years, market returns were over 10%. Past performance is no guarantee of results, but a mosaic of factors affects stock market returns, and taxes is only one of those factors.




SOURCE: Haver/FM

## Outlook

As 2020 comes to a close, Pallas Capital will continue to monitor the medical progress of the coronavirus as well as the pace of recovery in economic activity. Coronavirus active cases are stubbornly stable, while hospitalizations and death rates are much improved. Progress has been made on treatments and vaccines, but continued infections will slow the recovery.

Financial markets rallied in the third quarter as the economy and companies recovered from the trough faster than expected.  Clear industry winners and losers are evident from the pandemic.  The pace of recovery for the impacted industries will help determine the timing of a full recovery for corporate earnings.

The U.S. election will be front and center in this fourth quarter.  The election results may be delayed due to counting mail-in ballots, but markets are already pricing in more volatility in November than in 2021.  The eventual certainty of the election results will allow markets to begin discounting a mosaic of factors including the pandemic effect, taxes, stimulus, etc.  Pallas Capital will be vigilant in tracking these factors and their impacts on markets.

Sincerely,

**Mark A. Bogar, CFA** (R)
Chief Investment Officer
Pallas Capital Advisors