PALLAS
CAPITAL ADVISORS

PCA Monthly Commentary

November 2020

Risk-Off Environment Ahead of Election

October 2020 demonstrated a risk-off environment ahead of the 2020 U.S. election and a resurgence of the coronavirus. Global equity markets generally fell in October with the S&P 500 -2.7%, NASDAQ -2.3%, EAFE -4.1%, and the exception being Emerging Markets +2.1%. Fixed income performance was mixed with the Bloomberg Barclays US Aggregate -0.4%, as long-term rates edged up. US high yield improved by 0.5%. Commodities also fell with gold down 0.5%, and oil dropping 11.0%. As of the date of this publication on November 6th, 2020, the Presidential and Senate races are still undecided.

2020 ELECTION

2020 continues to be a historic year. Over 100 million citizens voted before election day by a combination of mail-in and in-person votes, which represents 73% of the turnout of the entire 2016 election. Joe Biden has received a record 73.5 million votes to Donald Trump's 69.6 million. The polls had another rough year of predictions, similar to 2016. Republican support was materially understated for races across the House, Senate, and President. While, at the time of publication, too early to call officially, the Senate appears to be staying with a Republican majority, while Joe Biden is leading the Presidential elections. Republicans also picked up seats in the House, contrary to expectations.

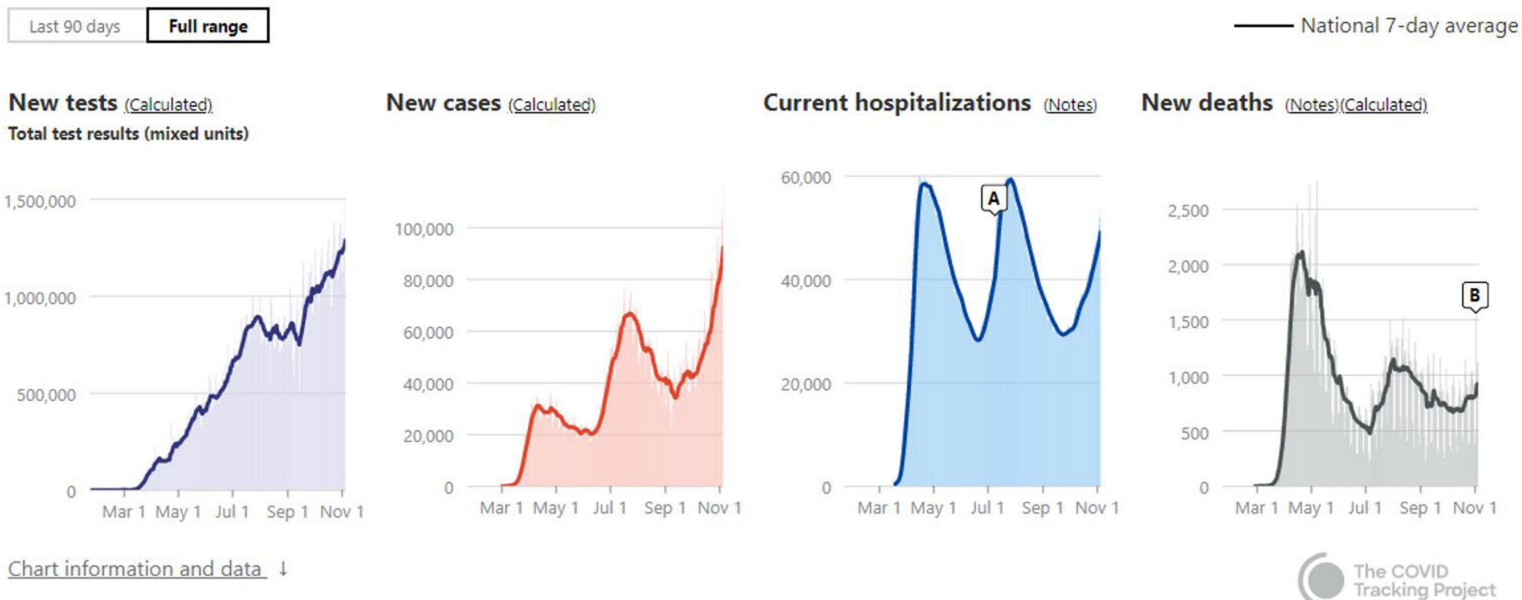
Market expectations heading into the election were for a Blue Wave of Democratic victories capturing the Presidency, the Senate, and the House. The wave could have emboldened the Democrats to implement a plan of higher taxes, additional coronavirus relief, more technology regulation, and infrastructure spending. Funding this agenda would most likely lead to higher deficits and potentially higher interest rates in the future. However, with the unexpected strength of Republicans across the board, the Blue Wave agenda will have difficulty being implemented, especially if the Republicans ultimately keep control of the Senate.

Implications for markets are varied. The checks and balances inherent in a divided Congress imply that fiscal spending will be tempered as Republicans and Democrats must reconcile their views. This potential lower spending would result in lower deficits and less U.S. Treasury issuance which can help keep interest rates lower for longer. Two sectors of the stock market that could be impacted are technology and healthcare. Large technology companies have been facing antitrust concerns from the government.

Generally, Republicans and Democrats differ on the specifics of antitrust issues and potential remedies. As such, a divided Congress will most likely result in a watered down regulation of these firms. Healthcare companies come under fire in most election cycles. As this cycle begins to fade and no new sweeping reforms are proposed, the market could start to remove the uncertainty discount from the healthcare sector.

SURGING CORONAVIRUS

With the nation's focus on the election, the coronavirus has surged both in the United States and globally. Testing has grown to 1.3 million tests a day. New cases have surged to over 100,000, and hospitalizations are ramping up. The death rate has stayed low but may rise as this latest surge plays out.

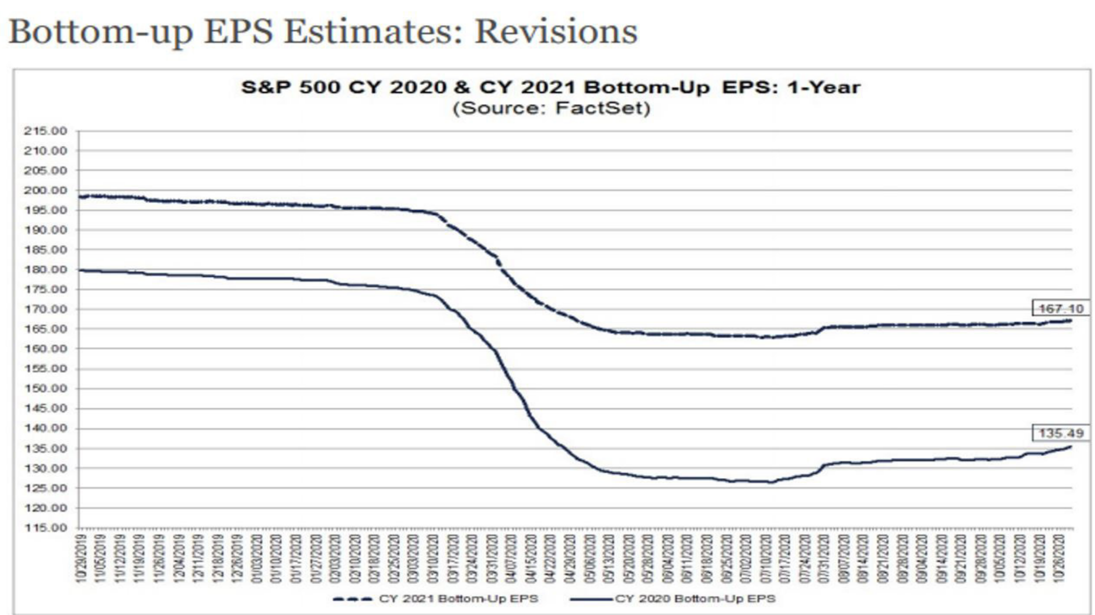


Source: covidtracking.com/data

With the surge in cases, states have implemented new restrictions to attempt to limit the spread of the disease. For example, Massachusetts imposed new rules on Friday, including a stay-at-home advisory, early closing of businesses at 9:30 pm, and a mandate to wear a mask in public regardless of any ability to socially distance. Progress continues to be made on vaccines and treatments, but no date has been set for a wide distribution of a vaccine. The bifurcation of the economy continues as online and technology businesses thrive while service sector business like restaurants and gyms are materially impacted by the disease.

Q3 EARNINGS SEASON HAS BEGUN

The dichotomy between Main Street and Wall Street can be measured by tracking the earnings trends of corporations in the S&P 500. Small service-oriented businesses are suffering, but larger corporations' health can be gauged by the trends in reported earnings. Corporate earnings took a large hit at the outset of the crisis, but they have been trending higher ever since as expectations have been improving.

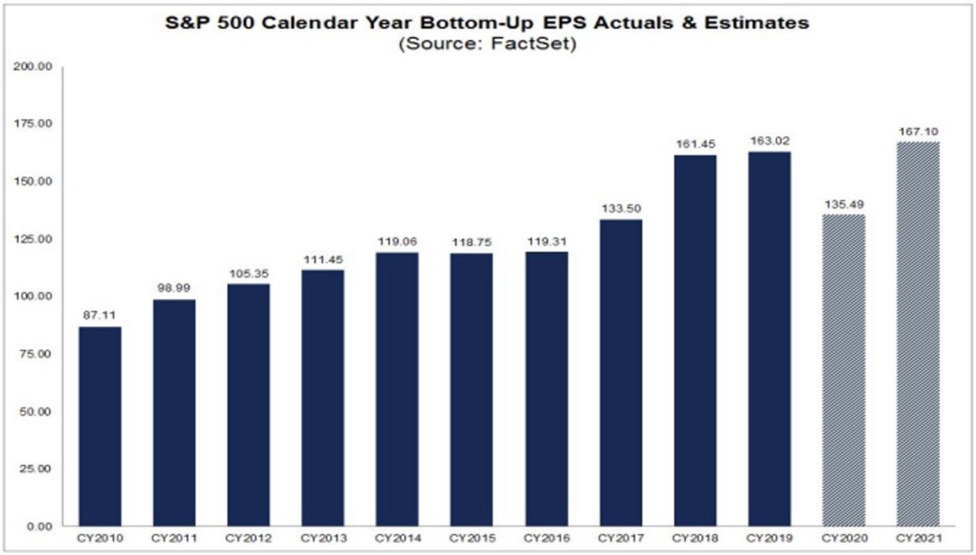


Source: Pallas Capital Advisors, Factset

Based on current forecasts, S&P earnings for 2021 of 167.10 will exceed 2019 earnings of 163.02. The forecasted earnings recovery is happening in an environment where the economy is not back to full potential.

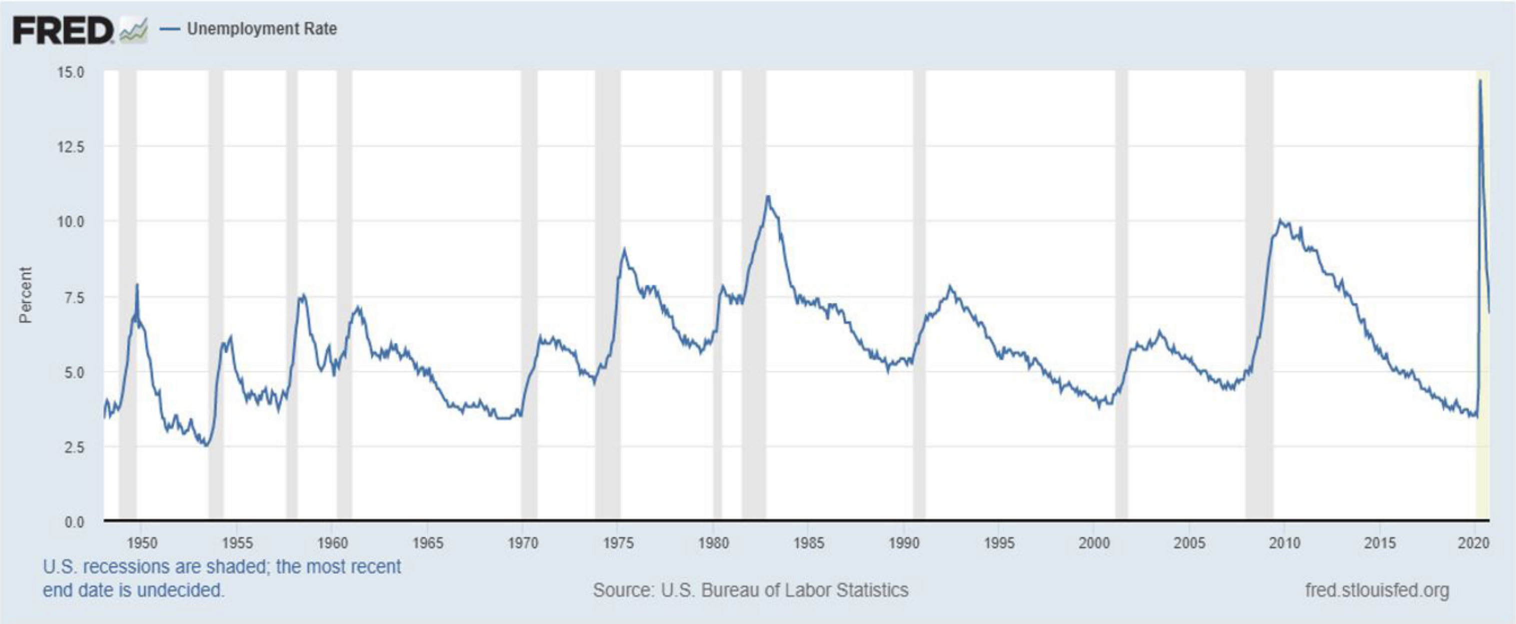
For Q3 2020 (with 64% of the companies in the S&P 500 reporting actual results), 86% of S&P 500 companies have reported a positive EPS surprise and 81% have reported a positive revenue surprise. If 86% is the final percentage, it will mark the highest percentage of S&P 500 companies reporting a positive EPS surprise since FactSet began tracking this metric in 2008.

Bottom-up EPS Estimates: Current & Historical



Source: Pallas Capital Advisors, Factset

While earnings have surprised positively, the unemployment rate dropped again to 6.9% from 7.9%. 6.9% still is representative of recession levels, but the trend is positive.



Source: Pallas Capital Advisors, fred.stlouisfed.org

CONCLUSION

The U.S. election is still not over at the time of this publication, as every vote continues to be counted throughout the country. The unexpected tight races across the Presidency, the Senate, and the House have reduced expectations of a Democratic Blue wave sweeping the country. A divided government typically reduces uncertainty for markets as less dramatic change is expected for companies. The coronavirus is raging throughout the country, necessitating new restrictions on activities. Despite the coronavirus, corporate earnings and macroeconomic data is improving. The team at Pallas Capital will continue to monitor macroeconomic, political, and company news for the impact on markets.

Sincerely,

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

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