PALLAS
CAPITAL ADVISORS

PCA Quarterly Commentary

Q4 2020

2020 - The Year of the Pandemic, Politics, and Rising Markets

Global markets rallied across the board in the fourth quarter of 2020 following the U.S. election in early November and the approval of vaccines to fight the coronavirus. The U.S. economy continues to produce mixed results as the country battles the coronavirus. The election and potential for a resumption of normal economic activity showed implications to equities, bonds, and commodities.

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
Q4 2020	12.1%	15.4%	31.3%	15.9%	19.7%	0.7%	6.5%
YTD 2020	18.4%	43.6%	20.0%	7.6%	18.3%	7.5%	7.0%

SOURCE: Morningstar, MSCI, Bloomberg, NASDAQ, Yahoo

Equity markets boomed in the fourth quarter. A weak October was driven by uncertainty over the U.S. election as well as continued coronavirus cases. Post-election, November and December demonstrated strong markets with the election largely resolved and news of the approval of coronavirus vaccines from Pfizer and Moderna. For Q4, the Russell 2000 (+31.3%) led the way with small-cap stocks partially closing the gap with technology for the year. Traditional cyclicals in the S&P 500 recovered from their YTD losses led by Energy (+28%), travel and leisure (+26%), and financials (+18%). Utilities and Telecom lagged the rally up only 6%. Corporate earnings trends broadly supported the rally as third-quarter earnings came in better than expected with estimates rising 2.3% (Factset). Estimates had been cut during the early stages of the pandemic, but many sectors have been able to recover faster than anticipated. Sectors driving the increase versus expectation include financials and technology stocks. The macro-environment for financials has been better than feared, while technology companies continue to perform well in the digital economy.

Fixed Income markets in Q4 also rallied with a 0.7% gain for investment-grade bonds (Bloomberg Barclays Aggregate) and 6.5% 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, reiterated the Fed's new inflation targeting policy. Rather than targeting a specific level of inflation (2%), the Fed will now target an average of 2% 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.

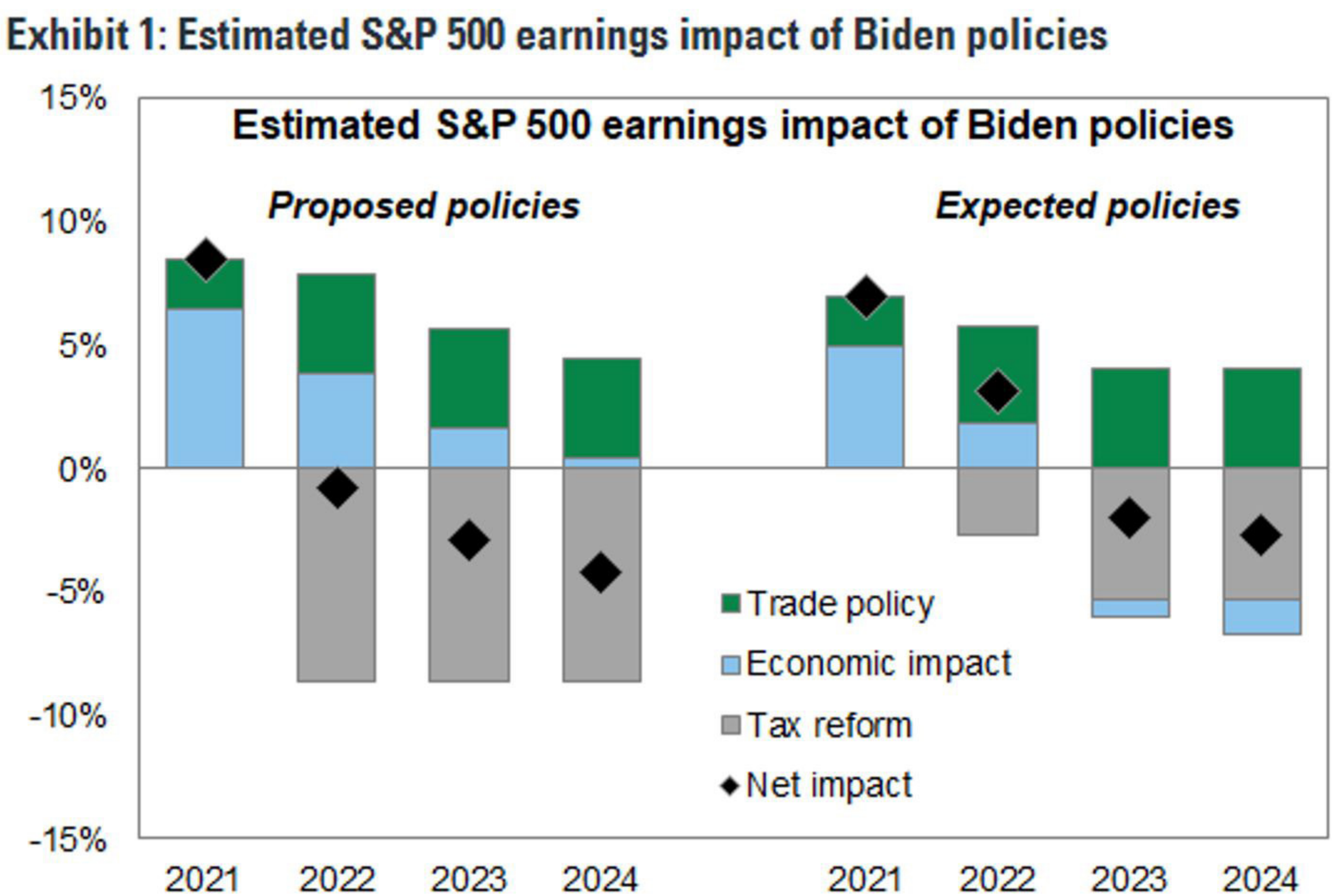
Commodity prices diverged with economically sensitive rallying and defensives relatively flat. Oil rebounded strongly in the quarter with the West Texas

Intermediate (WTI) oil price up over 20% to near $50 per barrel. Gold prices were essentially flat on the quarter. 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.

Federal Election Implications

The November 3rd U.S election provided much clarity to the political state of affairs with the January Georgia run-off Senate race providing the final pieces. The Democrats now control the Presidency, the Senate, and the House. While the Democrats hold the majority in Washington, they do so with a slim lead. Any legislative actions will most likely be constructed with an eye towards compromise with midterm elections two years away. The Democrat agenda will likely include more fiscal stimulus, infrastructure projects, and higher taxes to help foot the bill for the additional spending.

The Biden tax plan, if implemented as stated, would drive up taxes on corporations and individuals. Potential offsets to this could include a scaled-down tax plan, stimulative infrastructure spending, and lower tariffs. Goldman Sachs estimates (chart below) the impact to S&P 500 earnings with their estimates of a Biden tax plan, fiscal stimulus, and tariff reductions.



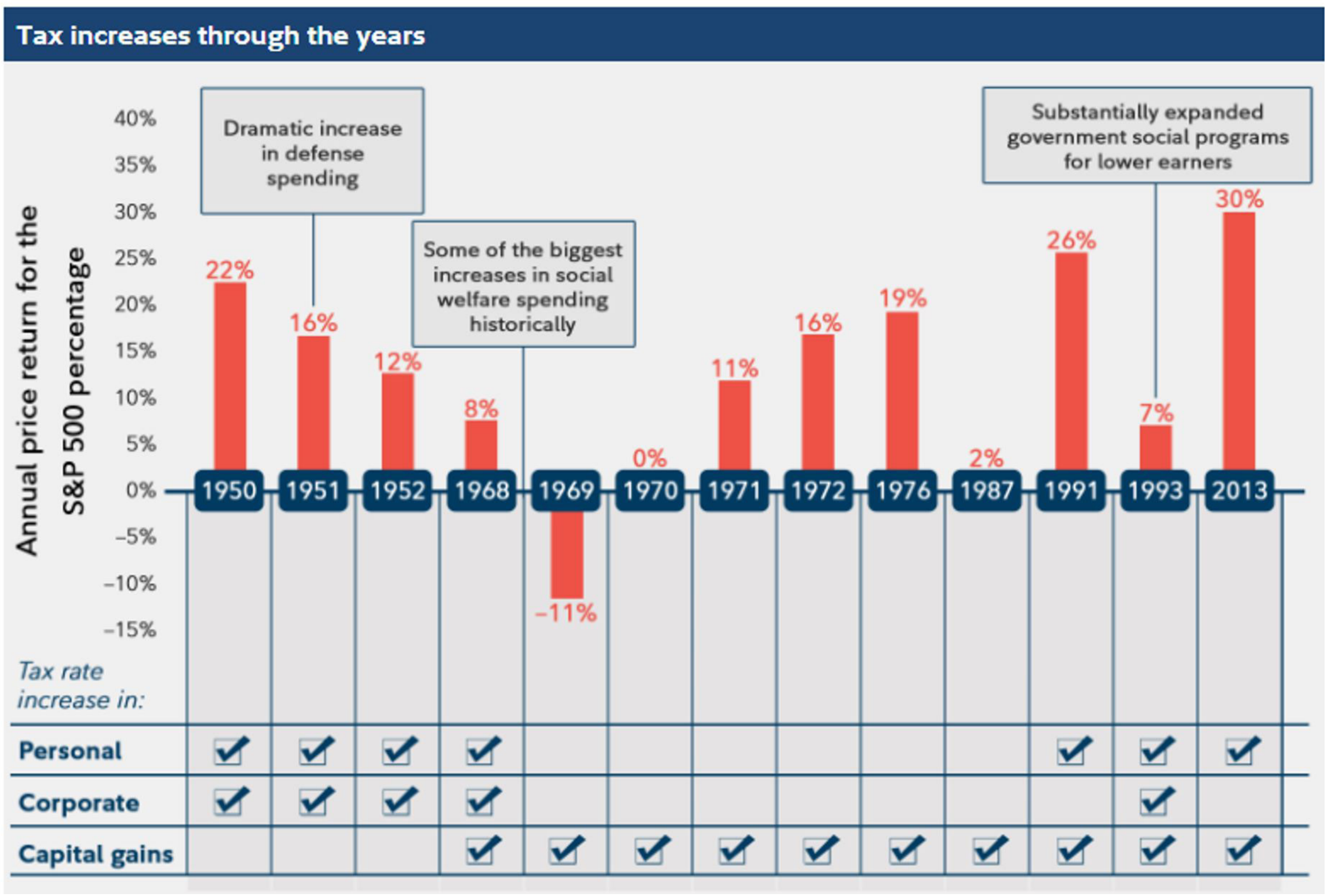
SOURCE: Goldman Sachs Global Investment Research

Under Biden's proposed policies, earnings would actually 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.

Regulation for large technology companies is also a risk with a unified government. The Democrats and Republicans often differ as to potential remedies for large technology companies' power within their markets. Social media companies such as Facebook and Twitter could be first up for a review given the events at the U.S. Capitol Building last week. Internet companies currently benefit from generally broad immunity under Section 230 of the Communications Decency Act of 1996. But as social media platforms can be used to promote criminal acts, the government is likely to introduce regulation to govern what speech may or may not be censored on these platforms.

MARKET IMPLICATIONS

Pallas Capital has analyzed past elections for its impact on equity markets from various angles. Most studies that are focused on long-run returns point 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 increases 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 income tax is only one of those factors.



SOURCE: Haver/FMR

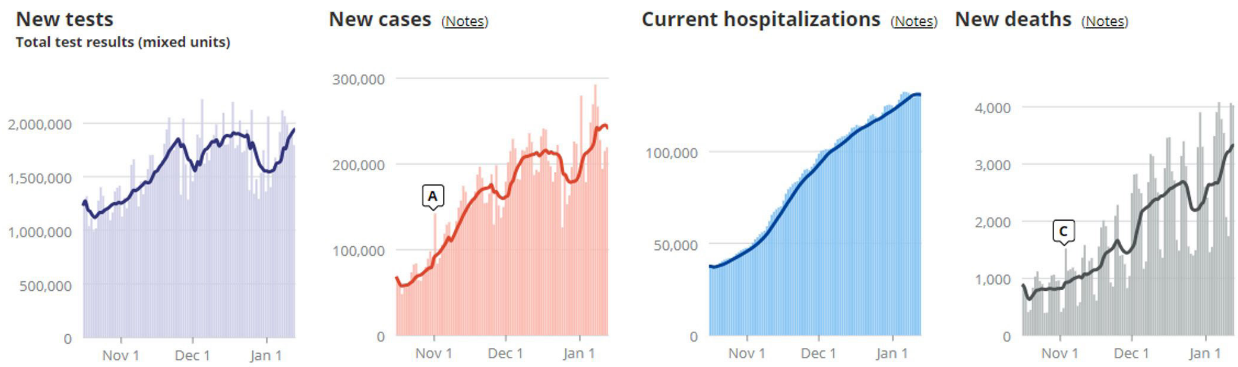
ECONOMIC TRENDS

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.

The post-Thanksgiving surge in cases has stressed many local healthcare systems nationwide. New cases are averaging over 200,000 per day, and hospitalizations have been sustained well over 100,000.

COVID vaccines are rolling out around the country although slower than expected. Pfizer's vaccine was the first to be approved followed quickly by Moderna. Johnson and Johnson and AstraZeneca also have vaccines in development that could be approved in 2021. The companies and the government are currently working to fix supply chain issues to speed up the roll-out of vaccines.

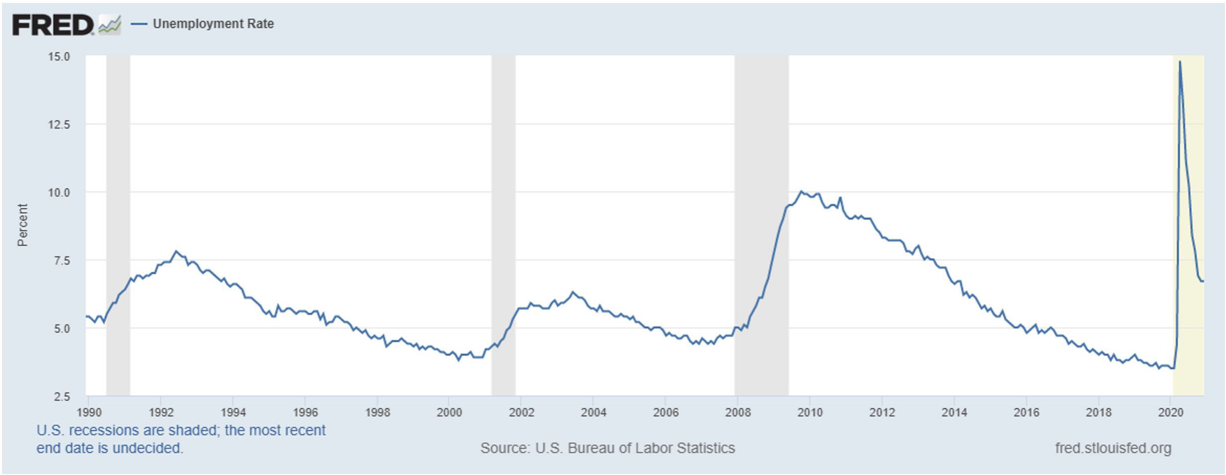
While the coronavirus maintains a presence in society, the economic impact has been dramatic. A dichotomy has developed with winners and losers among industries. Unemployment stands at 6.7% which is below other recession peaks but still above normal. Industries hardest hit include travel, leisure, restaurants, and gymnasiums. The economy will not be back to full strength until coronavirus restrictions are lifted to allow for these industries to recover.



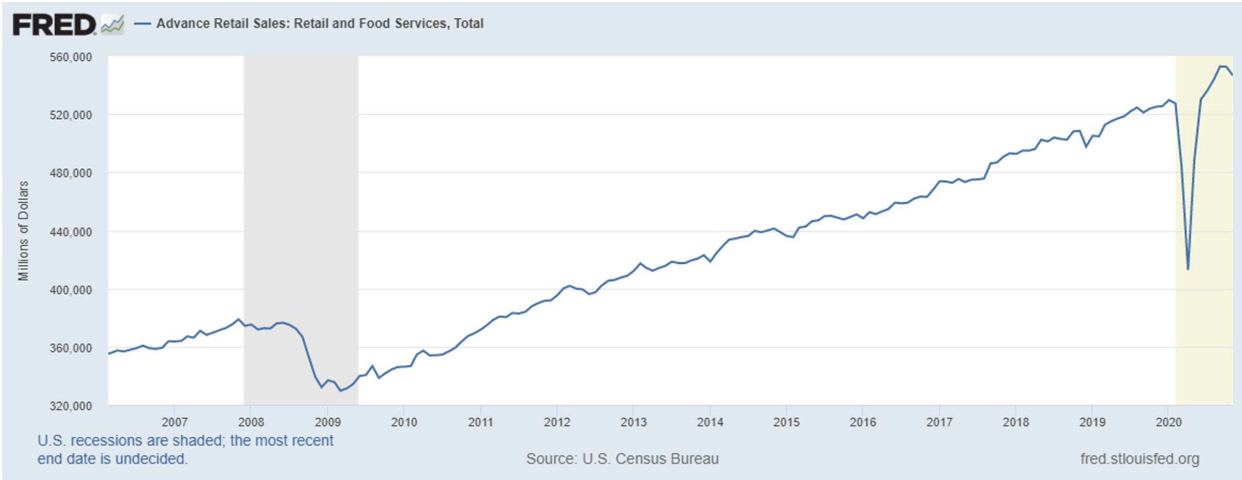
SOURCE: covidtracking.com/data

Despite the lack of full employment, retail sales have rebounded and exceeded pre-pandemic levels. Consumers at a macro level have restored spending faster than any recent recession. Beneficiaries include work from home industries, technology, 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 new stimulus package is likely in early 2021, which would help sustain spending until the economy can fully open.



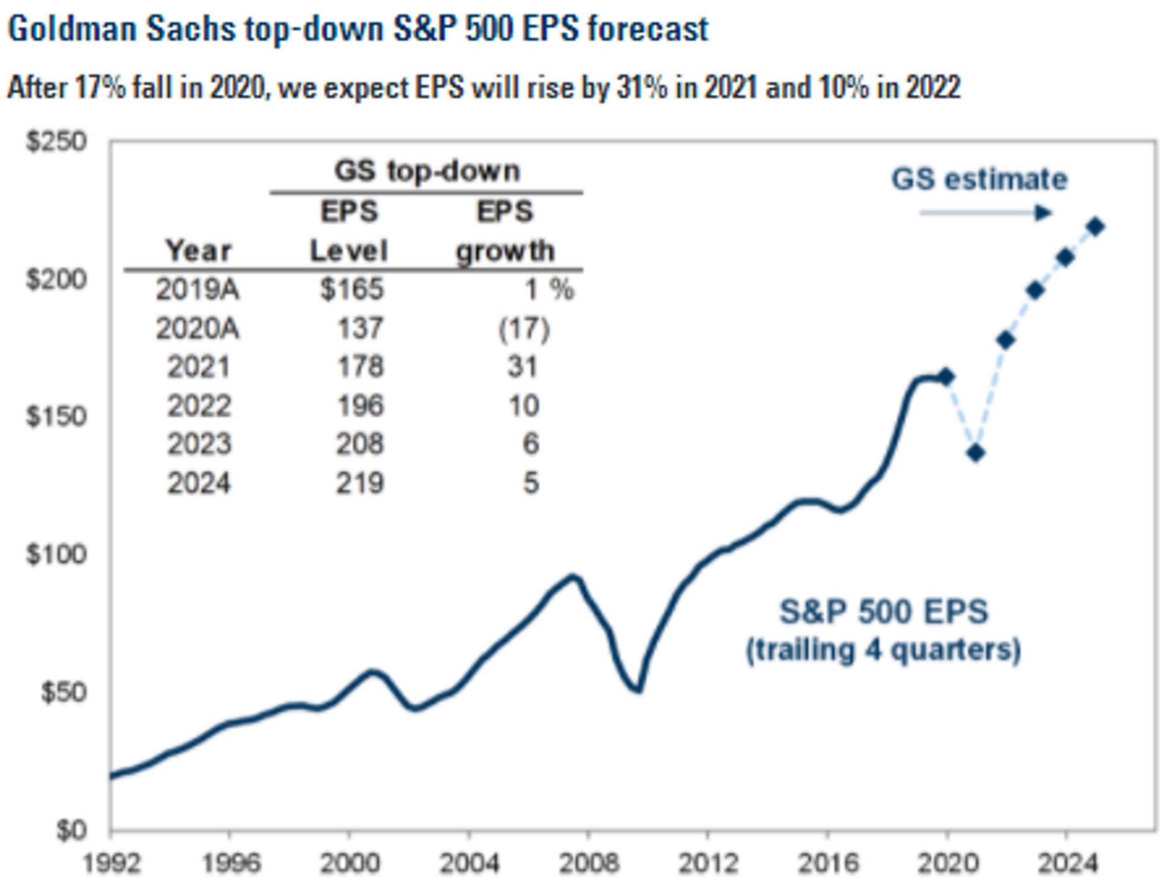
SOURCE: fred.stlouisfed.org



SOURCE: fred.stlouisfed.org

2021 Outlook

In constructing the mosaic of micro and macroeconomic factors affecting markets, we analyze forward earnings projections and valuations. David Kostin, Chief U.S. Equity Strategist at Goldman Sachs, recently published a piece addressing these factors. On an earnings front for the S&P 500, earnings are expected to fully recover from the pandemic in 2021 and grow to $178, rising to $196 in 2022. The recovery will be driven by cyclical sector recovery as well as continued strong earnings growth in the technology and healthcare sectors.

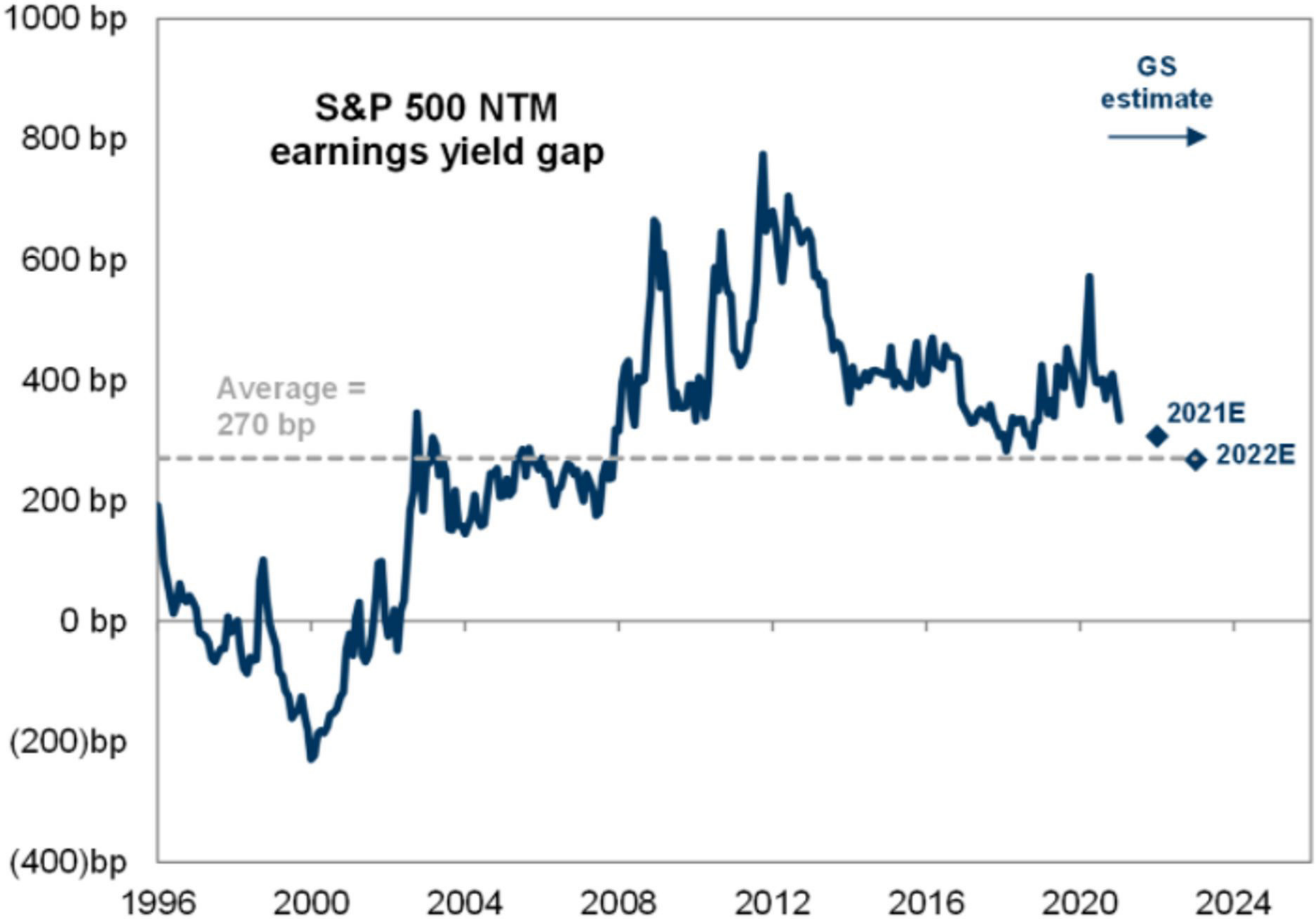


SOURCE: FactSet, Goldman Sachs Global Investment Research

While earnings are poised to recover, valuations in equity markets are attractive versus history relative to bonds. One way to measure this is by comparing the earnings yield of the S&P 500 to the yield on 10-year Treasuries. As can be seen on the graph below, in 1999 with the earnings yield in the market around 4.5% and treasuries around 6.5%, the yield gap was negative 200 bps making bonds attractive. However, at the end of 2020, the yield gap is positive 350 basis points with the earnings yield on the S&P 500 around 4.5% and Treasuries at 1.0%, favoring equities.

Relative valuation of equities is attractive vs. history

S&P 500 earnings yield gap vs. 10-year Treasury yield is above average



SOURCE: FactSet, Goldman Sachs Global Investment Research

2021 Outlook

2020 was truly a historic year. A global pandemic struck in March resulting in a stock market crash, followed by the fastest stock recovery from a crash in history. The healthcare community rallied to develop a vaccine within a year beating previous development time by years.

The Main Street economy, especially in the service industries sector, is still suffering from the effects of the lockdowns that are attempting to prevent the spread of the coronavirus. The new Democratic-led government in Washington is poised to pass stimulus packages to bridge the country to a full recovery. The cost of this program will most likely cause taxes to rise and raises the potential for inflation in the future.

Markets are forward-looking mechanisms that digest the entire mosaic of information. Corporate earnings are poised to recover while interest rates remain low due to Federal Reserve policies. Pallas Capital will be vigilant in tracking the pandemic, taxes, stimulus, corporate earnings, etc., and their impacts on markets.

Sincerely,

Mark A. Bogar, CFA®, CAIA®
Chief Investment Officer
Pallas Capital Advisors

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