PALLAS
CAPITAL ADVISORS

PCA Monthly Commentary

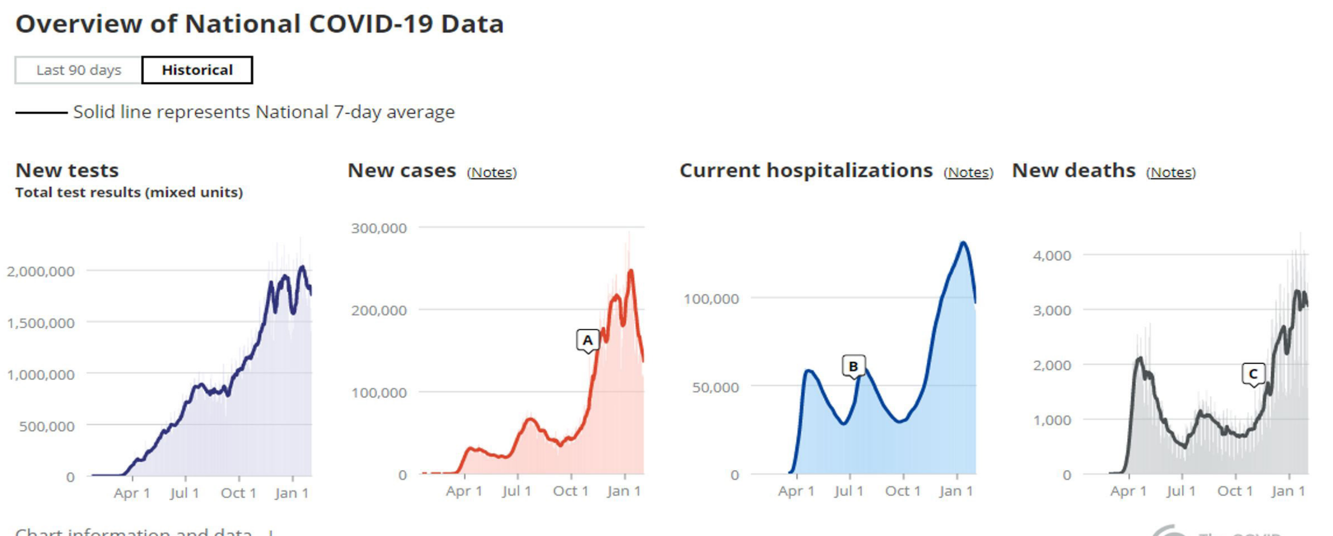
February 2021

A New Dawn

January 2021 brings a new year, a new government, and hope for relief from the coronavirus. Global equity markets were mixed with the S&P 500 -1.0%, NASDAQ +1.4%, EAFE -1.1%, and Emerging Markets +2.5%. Fixed Income performance was also mixed with the Bloomberg Barclays US Aggregate -0.7% and US high yield +1.0%. Cyclical commodities such as oil continued to rally +7.9%, while gold fell -2.0%.

CORONAVIRUS RELIEF IN SIGHT

The spike in daily new cases post-Thanksgiving is now declining with the new average below 130,000. Hospitalizations have also improved to under 100,000. Since vaccination efforts began in the US on December 14th, more than 32.2 million doses have been administered and more than 5.9 million people were fully vaccinated per the CDC. The US is currently administering around 1 million shots a day. Johnson & Johnson and Novavax reported positive data on their respective vaccine candidates, raising the prospects for more available vaccines as the year rolls on.



Source: covidtracking.com/data

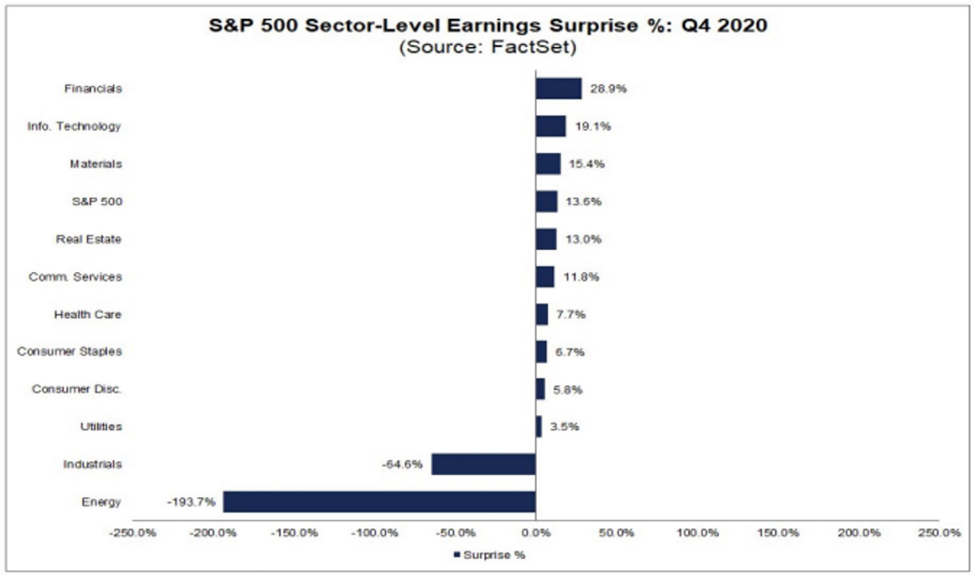
While the medical outlook improves for the coronavirus, the economic fallout is still being felt on Main Street, especially in service industries such as travel, gyms, and restaurants. Another round of federal stimulus would certainly help those severely impacted by the crisis. The Biden administration has proposed a $1.9 trillion plan, while Republicans have countered with a $600 billion stimulus package. The Democrats have the votes needed to pass their package but President Biden has indicated some willingness to lower the price tag for bipartisan support.

One component that may be left out could be the $15 minimum wage. Any relief package will help near term consumer spending and sentiment, driving better economic activity.

Q4 EARNINGS BETTER THAN EXPECTED THUS FAR

According to Factset, the Q4 earnings growth rate of the S&P500 is now positive, continuing the recovery from the pandemic. With more than 40% of S&P 500 companies having now reported, over 82% have beaten consensus forecasts, above the 75% one-year and 74% five-year averages. In aggregate, companies are reporting earnings 16.3% above expectations, better than the 11.9% one-year average positive surprise rate and the five-year average of 6.3%. Sectors with the most positive surprises are technology, financials, and materials, while energy and industrials have lagged. The technology sector was driven by themes around work from home and the accelerated e-commerce shift, which has been in place since the pandemic began. The financials sector companies earnings surprised positively, which was a change in direction from prior quarters.

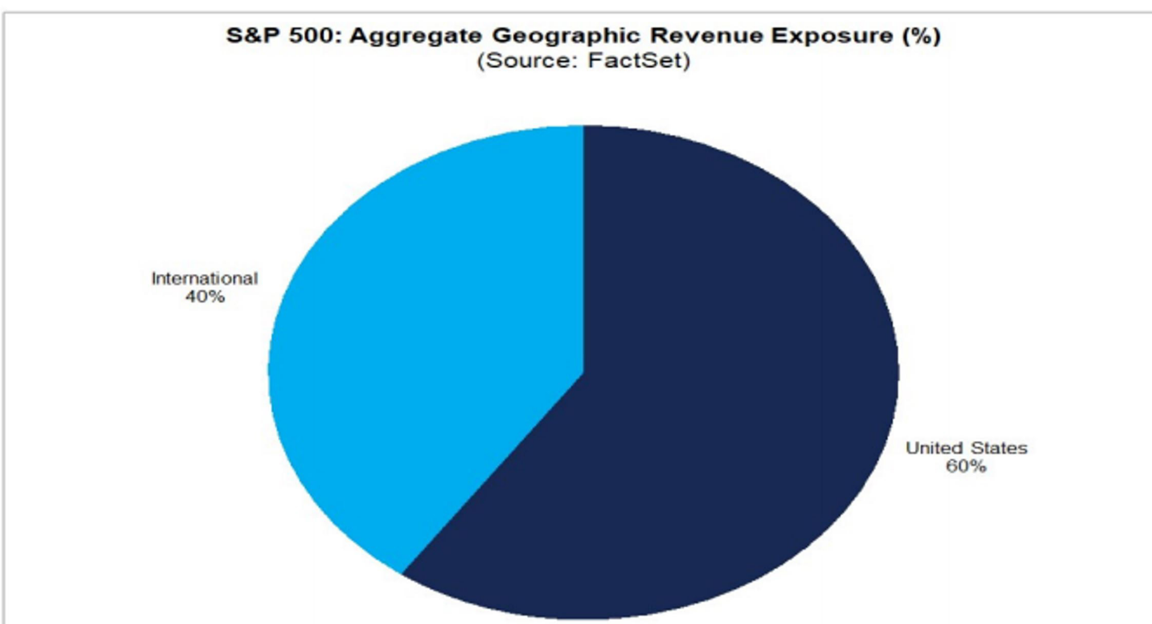
Q4 2020: Scorecard



Source: Pallas Capital Advisors, Factset

As global GDP recovers from the pandemic, international economies tend to recover at a faster rate given their higher exposure to sectors such as industrials, materials, and financials. One way for investors to potentially benefit from this recovery would be to buy international and emerging market stocks. Another would be to own S&P 500 companies with international exposure. The S&P 500 in aggregate has 60% revenue exposure to the US and 40% internationally.

Geographic Revenue Exposure



Source: Pallas Capital Advisors, Factset

MARKET OUTLOOK

The S&P witnessed earnings cuts of close to 30% in 2020 due to the pandemic. Recovery is predicted in earnings for both 2021 and 2022 from both Goldman Sachs and Consensus. If these forecasts are realized, S&P 500 earnings will exceed the original forecasts for 2020 in 2022.

S&P 500 earnings and valuation

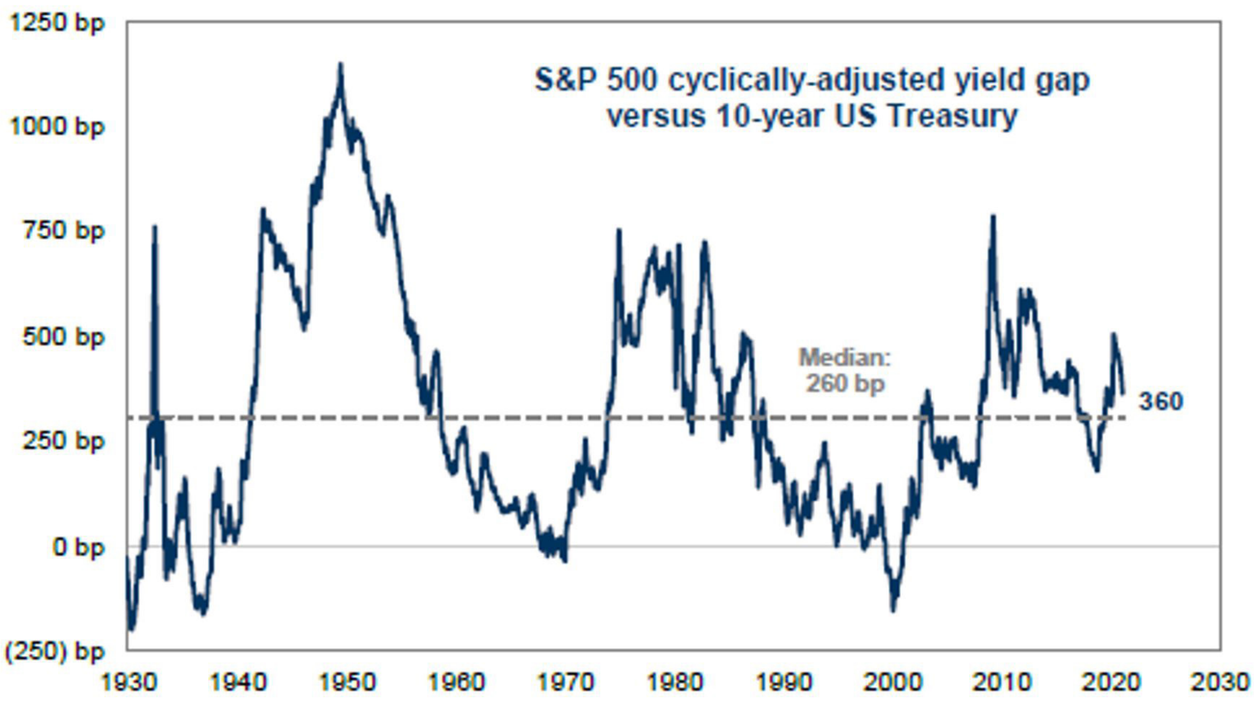
	Goldman Sachs Portfolio Strategy		Consensus Bottom-Up	
	2021E	2022E	2021E	2022E
EPS	$178	$196	$171	$198
Growth	31 %	10 %	22 %	16 %
	NTM	2022E	NTM	2022E
P/E	21.1x	19.3x	22.6x	19.1x

Source:I/B/E/S, FirstCall, Goldman Sachs Investment Research

While the strong earnings growth is impressive, valuations in the market are also reasonable. While the absolute multiples like P/E are near the higher end of historical ranges, valuations relative to US Treasury bonds are still attractive. One way to measure this is to compare the earnings yield on the S&P 500 with the 10 US Treasury bond. That gap is approximately 350 bps today. On an earnings level, an investor earns 3.5% more on stocks than bonds today. This yield gap is attractive for equities versus history.

Exhibit 3: S&P 500 cyclically-adjusted yield gap versus 10-year US Treasury

as of January 21, 2021



Source: Robert Shiller, Goldman Sachs Global Investment Research

Note, during the stock market bubble of 1999, this yield gap actually was close to -200 bps. In 1999, bonds were favored versus equities by 2.0% on this metric. Valuations today would favor equities.

CONCLUSION

2021 kicked off with a new US government and mixed capital markets as the cross current of news was digested. Coronavirus optimism improved as daily new cases dropped and vaccines began distribution. Washington debated a much-needed stimulus bill while corporate earnings came in better than expected. Valuations in equity markets appear reasonable given the direction of the economy and relative valuation to other asset classes.

Pallas Capital will continue to monitor macroeconomic, political, and corporate news for impacts on markets.

Sincerely,

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

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