PCA Quarterly Commentary

Q1 2021

ROARING 20's REDUX?

2021 is off to a fast start with jobs accelerating, vaccines rolling out, fiscal stimulus passed, and risk assets rising. Is the post-COVID US economy due for a roaring 2020's akin to the roaring 1920's post the 1918 Spanish flu? Only time will tell. This Pallas Capital Advisors Q1 2021 review will discuss the medical situation, economics, and government actions to judge the implications for 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 VLI Bond
Q1 2021	6.2%	3.0%	12.7%	4.0%	2.3%	-3.4%	0.6%

SOURCE: Orion

Equity markets marched higher in Q1. The Georgia Senate runoff election kicked off the year giving Democrats a sweep of the Presidency, US Senate, and US House. With many service industries still suffering from restrictions, an additional $1.9 Trillion relief bill was passed. With economic reopening in sight due to vaccinations, equity markets rallied. The Russell 2000 (+12.7%) led the way as small caps typically benefit more than large caps from an economic upturn. The sector allocations in small cap also are more weighted towards cyclical industries like financials and industrial.

This trend played out through US equity markets as the more balanced S&P 500 (+6.2%) outperformed the tech-heavy NASDAQ (+3.0%). The energy sector led the way in the S&P 500 up 30% for the quarter. Other strong sectors included industrial (+12%) and financials (+12%). High multiple growth stocks lagged with technology only up 4%, and utilities and telecom were also hurt by rising rates. International markets lagged the US as the US appears to be rebounding from COVID faster than other major economies.

Fixed income markets witnessed a diverging performance. Bond markets began to discount an economic recovery with rising real yields and inflation expectations. The 10-year Treasury rose to 1.74% at the end of the quarter from 0.92% at the end of 2020. Rising rates negatively impact long-duration bond prices which negatively impacted the Bloomberg Barclays Agg Index, driving it down -3.4% for the quarter. With the improvement in economic prospects, high-yield bonds rallied, up 0.6%. During the quarter, Federal Reserve Chairman, Jerome Powell, reiterated the Fed's dual mandate of full employment and price stability. Short-term rates are poised to stay lower for longer as the US economy is far from full employment as jobs are still impacted by COVID, and labor force participation has declined.

On the inflation front, 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. The oil rebound continued from Q4 with the West Texas Intermediate (WTI) oil price up over 20% to near $60 per barrel. Demand is picking up while supply has remained constrained following the pandemic, driving prices higher. In contrast, Gold prices fell almost 10% in the first quarter of 2021. Gold prices historically have performed best when real interest rates are falling, and as a store of value when other asset classes are falling. With the markets anticipating a recovery, real rates are rising along with risk assets, pressuring the gold price. Some market participants contend that Bitcoin may substitute for gold as a store of value in the future.

Federal Fiscal Spending

The January Georgia run-off Senate race provided the Democrats with control of the Presidency, the Senate, and the House. The Federal government wasted no time in passing a $1.9 Trillion COVID-relief bill. Near the end of the quarter, President Biden unveiled a $2.0 Trillion proposed infrastructure package, with his plan to revitalize US transportation infrastructure, water systems, broadband, and manufacturing. Specifics include:

- **$621 billion** for transportation infrastructures such as bridges, roads, public transit, ports, airports, and electric vehicle development
- **$400 billion** to care for elderly and disabled Americans
- **$300 billion** for improving drinking-water infrastructure, expanding broadband access, and upgrading electric grids
- **$300 billion** into building and retrofitting affordable housing, along with constructing and upgrading schools
- **$580 billion** in American manufacturing, research and development, and job training efforts

The Biden administration has argued that government infrastructure spending as a percentage of GDP has fallen over the past few decades, which has in his view necessitated this proposed increase in 2021.

President Biden also revealed his plan to pay for this infrastructure plan through specific tax raises and the elimination of loopholes. The main funding sources would include:

- Raise the corporate tax rate to 28% from 21%
- Boost the global minimum tax for multinational corporations to ensure they pay at least a 21% rate in any country
- Close various corporate loopholes including writing off expenses related to offshoring

The proposed increase in the corporate tax rate would reverse the corporate tax decrease the Trump administration put through in 2017 that dropped the rate from 35% to 21%. The Biden plan does not have universal support from Democrats, and so this plan should be viewed as a starting point for negotiations. Some Democrats have voiced concern with the corporate tax rate going as high as 28%.

With trillions of dollars of fiscal spending still to hit the US economy and possibly more to come with an infrastructure bill, the near-term economic impact should be positive. Consumers will have money to spend until the economy can fully reopen. Repercussions from fiscal stimulus may include potential tax increases down the road and inflationary pressures. Markets will have to wait to have a final determination of the implications to the economy.

Coronavirus Update

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. Active new cases have ticked up to over 70,000 per day as economies are reopening. Vaccinations are making steady progress with over 170 million shots administered as of 4/7/2021. 3 million shots are being administered every day, and 33% of the US population has a least one shot. The rapid progress made in vaccinations is truly historic.

In other vaccine news this quarter, the Pfizer-BioNTech coronavirus vaccine was shown to be extremely effective in young adolescents. No symptomatic infections were found among children aged 12 to 15 who received the vaccine in a recent clinical trial, the drug makers said. The children produced strong antibody responses and experienced no serious side effects. Depending on regulatory approval, vaccinations could begin before the start of the next academic year for middle school and high school students, and for elementary school children not long after. Vaccine news was not universally positive with AstraZeneca having both manufacturing issues and potential blood clot issues with their vaccine.

Total Vaccine Doses	
Delivered	225,294,435
Administered	171,476,655

Learn more about the distribution of vaccines.

People Vaccinated	At Least One Dose	Fully Vaccinated
Total	109,995,734	64,422,618
% of Total Population	33.1%	19.4%
Population ≥ 18 Years of Age	109,408,066	64,286,560
% of Population ≥ 18 Years of Age	42.4%	24.9%
Population ≥ 65 Years of Age	41,793,053	31,413,778
% of Population ≥ 65 Years of Age	76.4%	57.4%

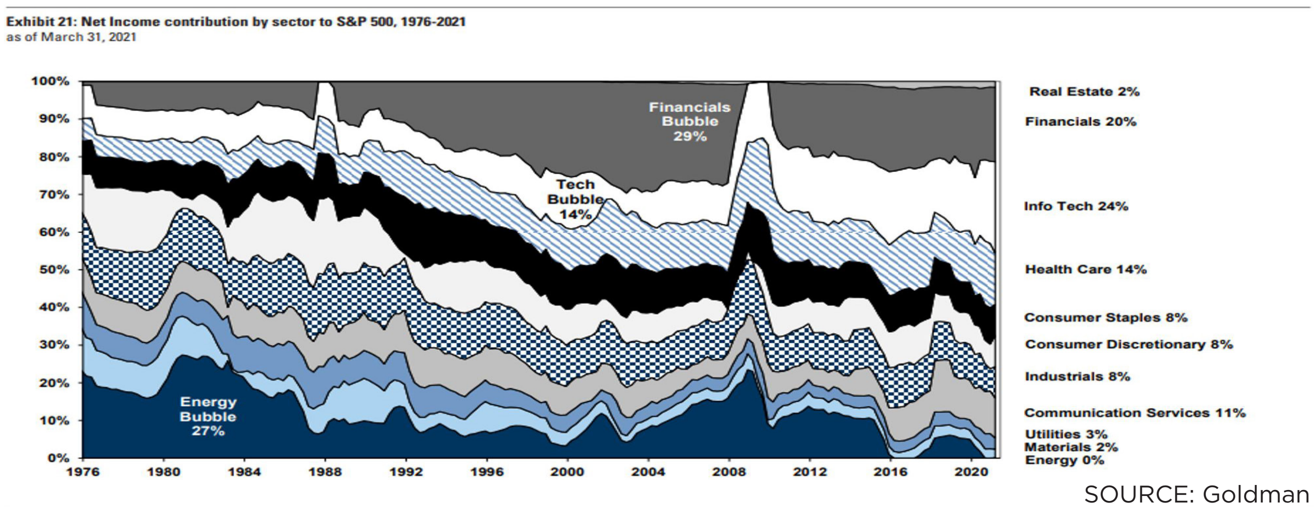
About these data

CDC | Data as of: Apr 07 2021 6:00am ET | Posted: Apr 7 2021 1:35PM ET

SOURCE: https://covid.cdc.gov/covid-data-tracker/#-

2021 Outlook

In constructing the mosaic of micro and macro-economic factors affecting markets, we analyze forward earnings projections and valuations to assess equities. On an earnings front for the S&P 500, earnings are expected to grow by 26% in 2021 and by a further 15% in 2022 to a level of 201. This increase is driven by continued growth in technology sectors while cyclical sectors fully recover from the coronavirus by 2022. The price-to-earnings ratio is around 20x's which is a reasonable value given current interest rates. Comparisons on valuations in the technology sector have been made to the 1999 tech bubble. A key difference today is that the earnings of the technology sector make up a much higher percentage of the S&P 500, anchoring the valuation. At the peak of the tech bubble, Information Technology never granted more than 14% of the S&P 500's earnings. The profit contribution from Info Tech increased over the past few years and the sector now accounts for 24% of the S&P 500 net income (Goldman Sachs).



SOURCE: Goldman Sachs

On the fixed income front, nominal rates remain low versus history. Duration risk is most concerning to us, and the rise in long-term rates this year has driven down the value of long-term Treasury bonds. Short-term rates are poised to stay low as the Federal Reserve focuses on high unemployment and lack of sustained inflation. Credit risk is attractive as the economy recovers while high-duration bonds will be hurt by higher rates.

Outlook

2021 is off to a roaring start with equity markets rallying, and the economy rebounding. The recent fiscal stimulus programs have yet to fully hit the economy which should spur on near-term activity, but repercussions could be felt down the road in terms of higher taxes and interest rates. 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, and more for the impacts on markets.

Sincerely,

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