PCA Monthly Commentary

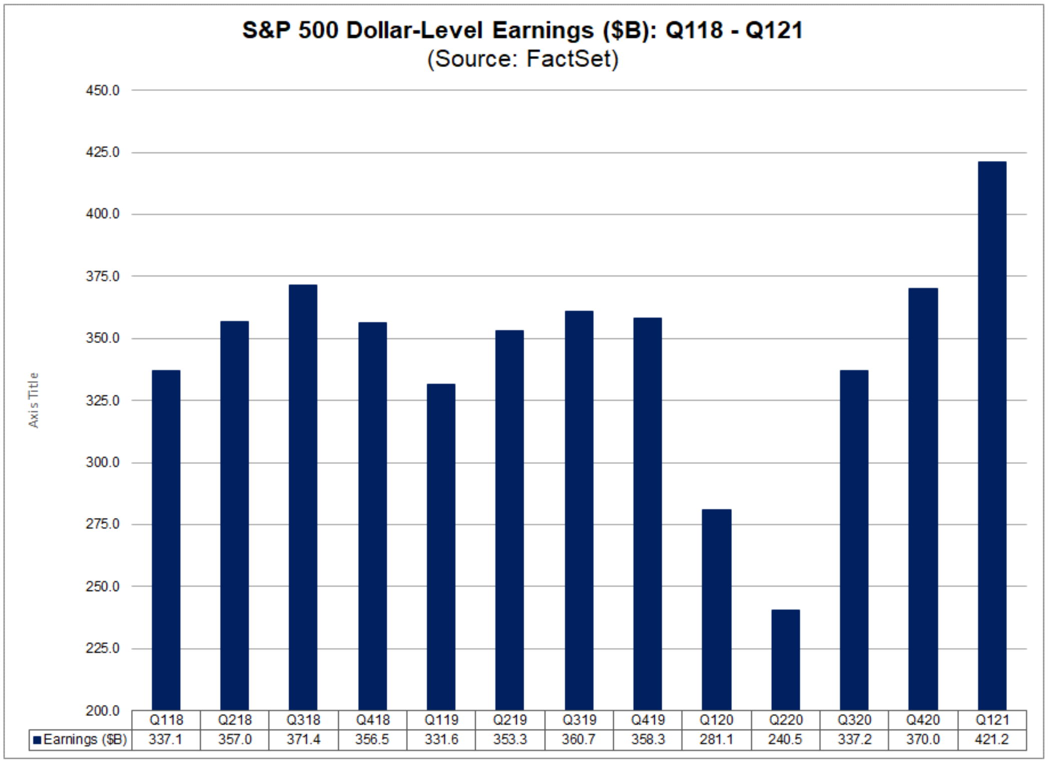
May 2021

Record Job Openings and Rebounding Inflation

April 2021 witnessed markets rallying on strong corporate earnings and vaccinations steadily progressing in the US. Markets in May have turned to macroeconomic data sending conflicting signals around record job openings and spiking inflation figures. Global equity markets in April rose with the S&P 500 +5.3%, NASDAQ +5.4%, EAFE +3.0%, and Emerging Markets +2.5%. Fixed income performance was also positive with the Bloomberg Barclays US Aggregate +0.8% and US high yield +1.0%. Cyclical commodities rallied with oil +6.4% and gold +3.0%.

HISTORICALLY STRONG S&P 500 EARNINGS

Q1 S&P 500 earnings season is wrapping up demonstrating growth of 49.4% YOY in Q1 versus an expected 23.8% (Factset). Clearly, the YOY percentage gain is aided by easy comparisons versus the beginning of the shutdown of the global economy last year. However, 86% of companies exceeded expectations in the quarter which shows corporate earnings are recovering much faster than anticipated. One way to view the magnitude of earnings is through the aggregate dollar amount reported which rose to $421 billion in Q1 (Factset).

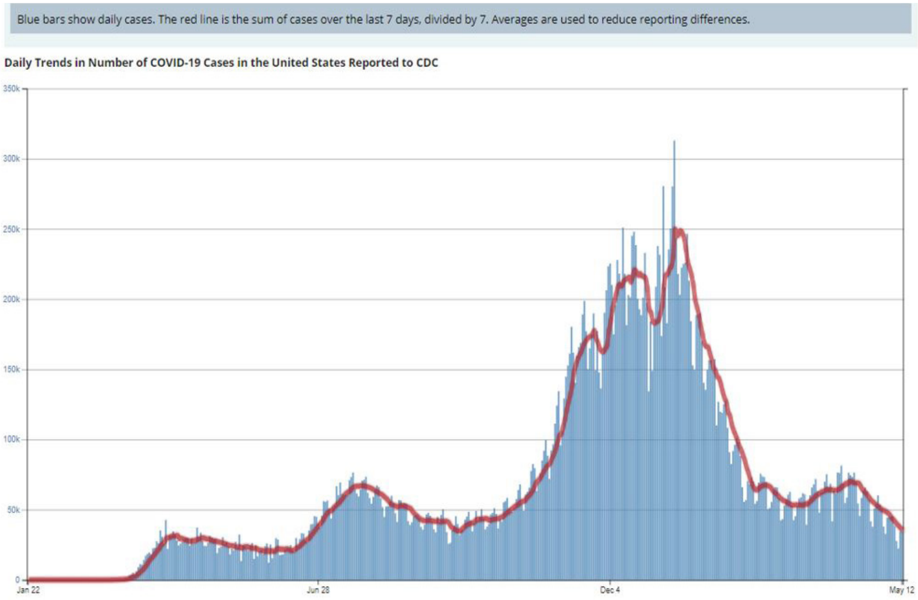


SOURCE: https://insight.factset.com/sp-500-earnings-growth-rate-for-q1-is-now-more-than-double-the-estimate-on-march-31

The earnings recovery is clearly on track helping to support equity markets. At a sector level, financials were the biggest driver of this increase with banks leading the way driven by better loan loss reserves, higher trading income, and stronger markets. Technology was the second-best group as software remained strong while the semiconductor industry came roaring back despite global chip shortage. Advertising spend drove a recovery in the Communication sector with names such as Google and Facebook benefiting. A sector showing difficulties was Healthcare. Many companies in the sector are still being impacted by the coronavirus with underutilization of the healthcare system. As the economy opens, elective surgeries and people getting back to normal doctor visits should drive profits and utilization higher.

VACCINATIONS DRIVING LOWER ACTIVE CORONAVIRUS CASES

Since vaccination efforts began in the US on December 14th, more than 264 million doses have been administered and more than 117 million people were fully vaccinated per the CDC. The US is currently administering around 2.2 million shots a day, down from over 3 million as the supply of vaccines is beginning to catch up to demand. Daily new coronavirus cases in the US are now averaging back below 36,000 per day. The largest decreases in cases are in states with the highest vaccination rates.



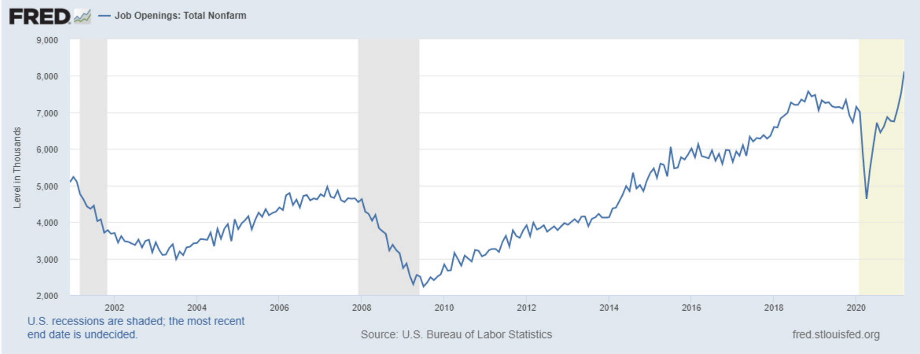
SOURCE: https://covid.cdc.gov/covid-data-tracker/#trends_dailytrendscases

CDC ANNOUNCES UPDATED GUIDELINES

On May 13th, the Centers for Disease Control and Prevention announced that fully vaccinated adults can safely resume activities indoors or outdoors without masks or distancing, in gatherings large or small. The announcement marks a major milestone in the effort to emerge from the coronavirus pandemic in the United States. Under the new guidance, fully vaccinated people can resume domestic travel without needing to get tested before or after, and they do not need to self-quarantine. They also do not need to quarantine following a known exposure so long as they are asymptomatic. This announcement marks another milestone in the path to normalcy.

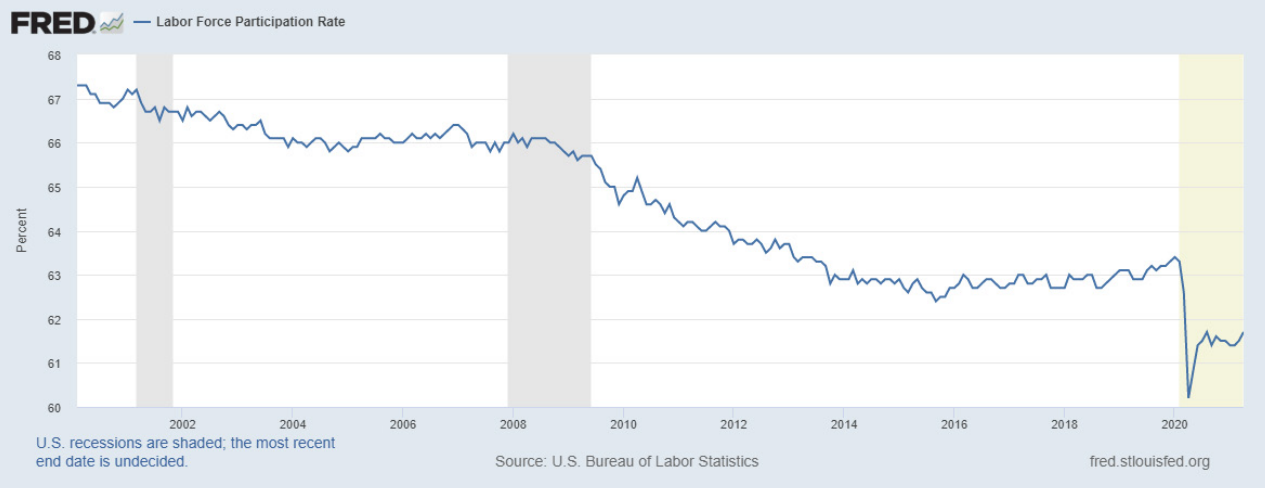
CONFLICTING MACROECONOMIC DATA

Recently reported inflation data has exceeded expectations, and the question on the market's mind seems to be is this inflation temporary or more permanent? While near-term inflation is high, the Federal government has proposed even more fiscal spending. Inflation in April accelerated at its fastest pace in more than 12 years as the U.S. economic recovery kicked into gear and energy prices jumped higher. The Consumer Price Index (CPI) jumped .8% month to month versus .2% expected which equated to 4.2% year over year. Producer Prices (PPI) also spiked up .6% versus .3% expected, equally 6.2% year over year. Both the market and the Federal Reserve had been expecting an increase in inflation in the short run as supply/demand imbalances are persisting in the economy due to the uneven reopening across industries. This data set year over year is also comparing against very low numbers due to the onset of the pandemic. The Fed is likely to wait until the economy is through this transition period and back to full employment before making any decisions on raising short-term interest rates.



One example of distortions in the economy is in the labor market. Job openings at eight million have set a 20 year high as businesses begin to open up and are seeking employees.

However, even with job openings hitting record highs, labor force participation is hitting near recent record lows around 62%.



With job openings so plentiful, why are people choosing to stay out of the workforce? Many reasons have been postulated. Schools are not fully open yet, and as such working parents still have childcare issues. Some parts of the population are still concerned about the coronavirus due to the lack of full vaccinations or herd immunity. Federal unemployment benefits may be exceeding the wages some workers could earn upon returning to work thus keeping them on the sidelines. Wages may be too low, and if wage inflation persists, the Fed may be forced to raise interest rates sooner than later. Whatever the factors driving the current eight million job openings, the normal run rate should be more easily judged come the fall when school is back in session and the country is closer to normal activity.

CONCLUSION

Corporate earnings surprised on the upside in Q1, providing support to a recovery in earnings power as 2021 progresses. Coronavirus optimism improved as daily new cases dropped, vaccinations continued, and the CDC lifted the mask mandate for many situations. Macroeconomic data is difficult to interpret due to the uneven economic opening with short-term inflation spiking and plenty of job openings. Pallas Capital will monitor macroeconomic, pollical, and company news for impacts on markets.

Sincerely,

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