PALLAS
CAPITAL ADVISORS

PCA Monthly Commentary

July 2021

Rally Rolls On - Q2 2021

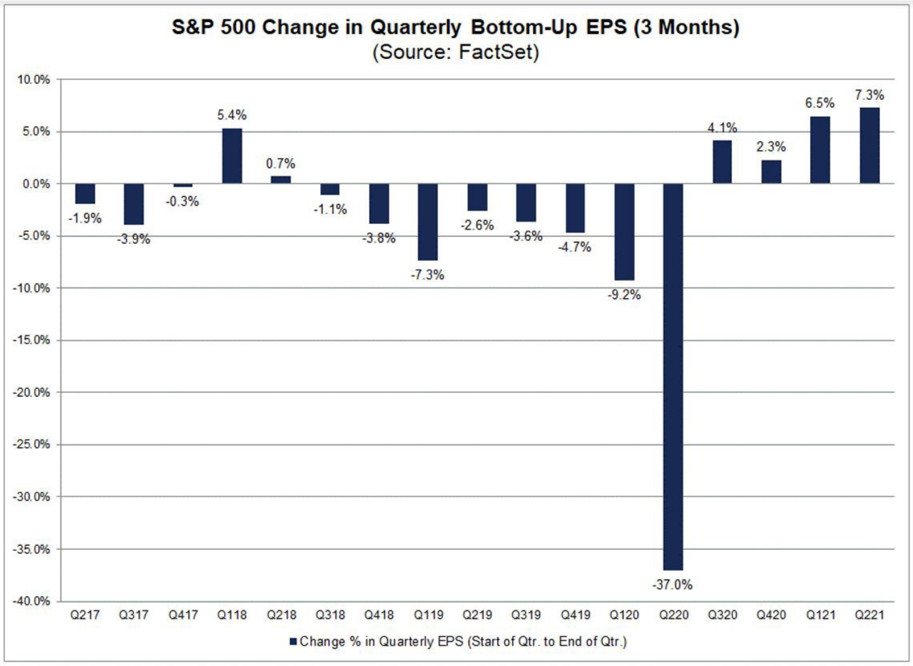
The recovery rolled on in the second quarter of 2021 with strong economic data, positive corporate earnings, and thriving stock markets. Not all signals are positive, however, as long-term rates are falling and near-term inflation is high. This Pallas Capital Advisors Q2 2021 review will discuss markets, 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
Q2 2021	8.5%	9.7%	4.3%	5.6%	5.0%	1.8%	2.4%
YTD 2021	15.3%	12.9%	17.5%	9.9%	7.4%	-1.6%	3.0%

SOURCE: Orion

Equity markets marched higher again in Q2. The quarter began with a continuation of the cyclicals rally and ended with technology names joining the party. Rising vaccinations, opening economies, and strong corporate earnings drove the positive price action. Corporate earnings surprises versus expectations were highest since FactSet started tracking estimates in 2002.



SOURCE: FactSet https://insight.factset.com/record-high-increase-in-sp-500-eps-estimates-for-q2

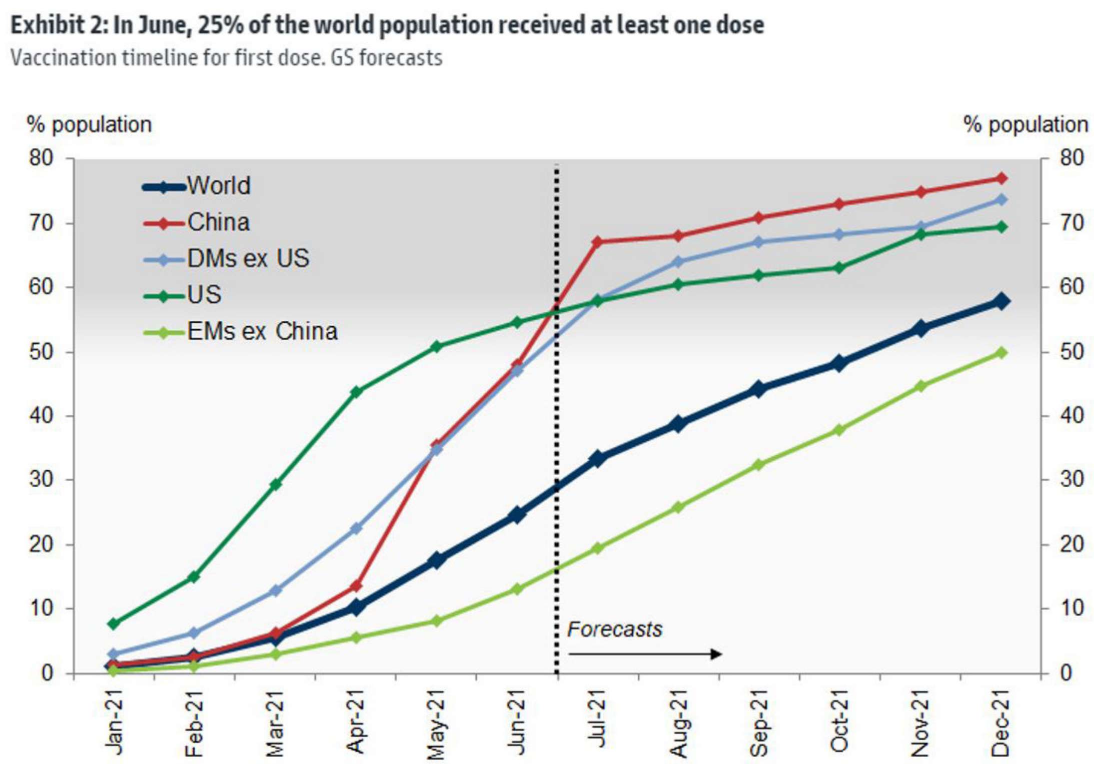
NASDAQ led the rally up 9.7% for Q2 as technology stocks joined the rally. The S&P 500 was also strong (+8.5%) as large-capitalization stocks did well during the earnings season. US small caps (Russell 2000 +4.3%) and international markets (MSCI ACWI ex-US +5.6%) were up but lagged the US large-caps. The technology sector led the way in the S&P 500 up 13% for the quarter. Other strong sectors included energy (+11%) and financials (+8%). Utilities and telecom lagged the rally due to their defensive nature. International markets lagged the US as concerns around the coronavirus appear to be higher for these economies.

Fixed income markets also rallied with the Bloomberg Barclays Agg Index up 1.8% and the Bloomberg Barclays High Yield Index up 2.4%. Treasury rates peaked in late March at 1.71% and actually fell to 1.45% on June 30th driving bond prices higher. High-yield performed even more strongly as the booming economic data enabled credit spreads to tighten. The market will be watching economic data and the Federal Reserve commentary for clues as to when the Fed may begin the tapering of monetary stimulus.

Commodity prices rallied on the back of economic momentum. The oil rebound has been unabated since Q4 2020 with the West Texas Intermediate (WTI) oil price up over 24% during Q2 to near $73 per barrel. Demand is picking up while supply has remained constrained post the pandemic driving prices higher. Gold finally joined the rally up +3.7% for the quarter. Gold prices historically have performed best when real interest rates are falling, and as a store of value when other asset classes are falling.

CORONAVIRUS UPDATE – DELTA VARIANT CONCERNS

The coronavirus pandemic continues to be the largest macroeconomic driver as the pace of the economic recovery will be determined by how quickly the world can safely get back to normal activity. Despite many variants of coronavirus, the US economic recovery remains on track given the relatively high level of vaccinations throughout the country. However, other countries around the globe lag in vaccination rates which forces various closures of economic activity. For example, Tokyo announced that they will not allow any spectators to watch the Olympics, and Sydney, Australia has extended a lockdown order due to the Delta variant. The primary issue with the lower vaccination rates in some countries is their access to the vaccine.

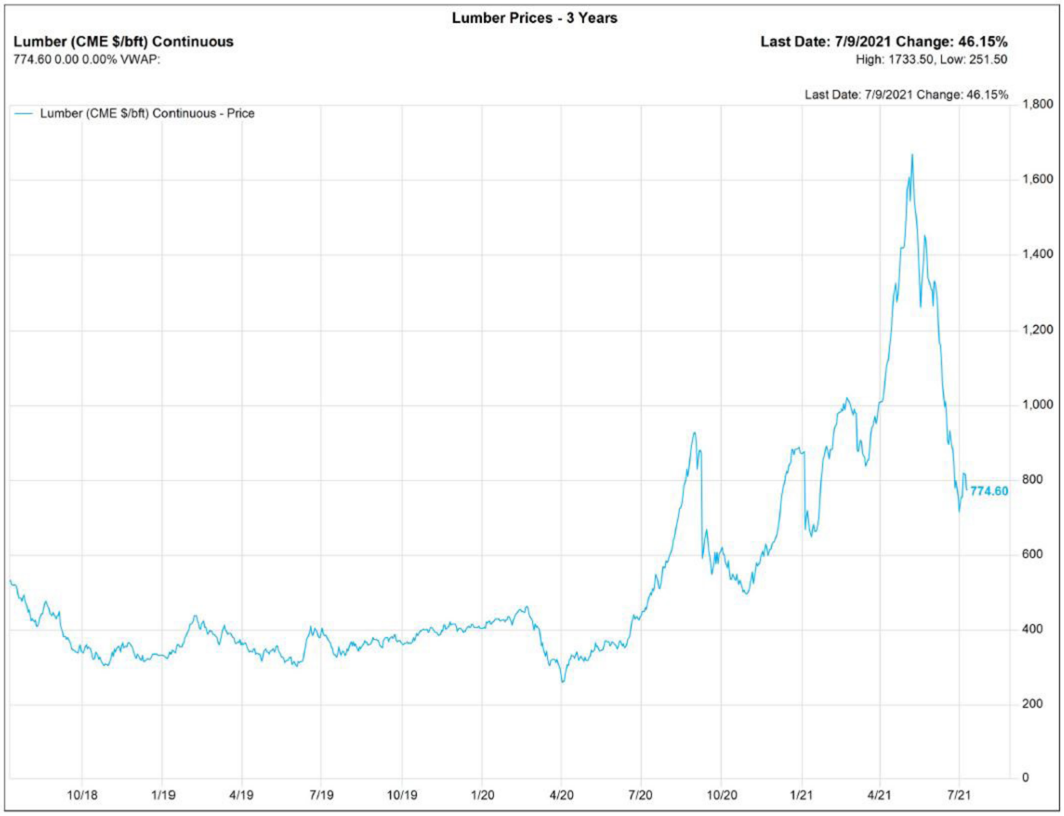


SOURCE: Goldman Sachs Global Investment Research

While the Delta variant is a concern, vaccines do seem to be effective against it, and countries around the world are making steady progress towards vaccinating their populations. According to Goldman Sachs research, 25% of the world population have received at least one dose.

If these forecasts come to fruition with increased supplies of vaccines, the rest of the world will be able to catch up to the US and work their way back towards normal activity in the fourth quarter and into 2022.

FALLING US TREASURY YIELDS



SOURCE: FactSet

The second quarter witnessed US Treasury yields falling despite the recovery in the economy and markets. A few theories have been posited to explain this. One is technical – the Federal Reserve continues to be in the market buying Treasuries. Additionally, some traders may be closing out bets on higher rates by also buying Treasuries. A second explanation could be concern around global growth given the rise of the Delta variant which would pressure yields lower. A third could be that inflation has already peaked. For example, lumber prices have already begun to fall towards their longer-run average despite the housing market still being strong.

The question remains as to whether the inflation spike witnessed by markets is transitory, driven by supply chain disruptions as the economy opens, or more permanent in nature. The Fed appears to still be in the camp that the inflation is transitory as they balance their dual mandate of full employment and price stability.

2021 MARKET 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 37% in 2021 and by a further 12% in 2022 to a level of 211. 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. On the fixed income front, nominal rates remain low versus history and have trended lower recently. Credit risk appears to be attractive as the economy recovers, while high duration bonds could be hurt if rates move higher.

OUTLOOK

2021 is off to a roaring start with equity markets rallying, and the economy rebounding. The recent fiscal stimulus programs have positively impacted the economy with potentially more to come, 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. The Delta variant of the coronavirus is a concern for a full global recovery until vaccine penetration is higher. Pallas Capital will be vigilant in tracking the pandemic, taxes, stimulus, corporate earnings, and their impacts on markets.

Sincerely,

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

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