

PCA Monthly Commentary

August 2021

Delta Dilemma

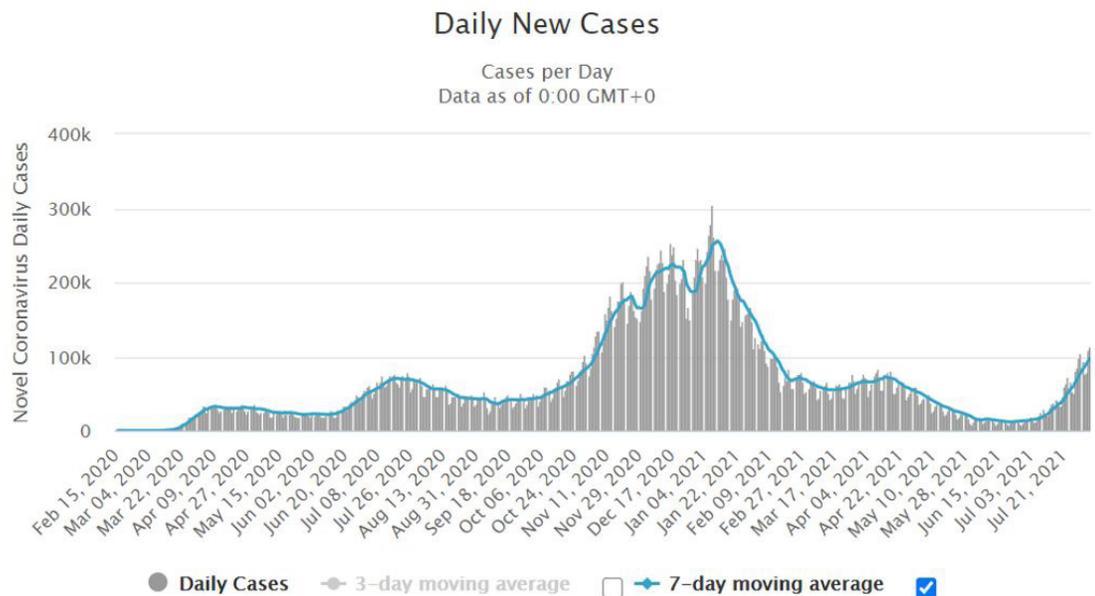
Markets generally moved higher in July 2021 led by the technology and healthcare equity sectors. The coronavirus Delta variant surged throughout the country driving a flight to safety in many indices. Traditionally, more defensive equity markets rallied with the S&P 500 +2.4%, NASDAQ +1.2%, and EAFE +0.8%, while the more cyclical Russell 2000 fell -3.6% and Emerging Markets were down -6.7%. Fixed income performance was positive with interest rates falling as Delta variant cases rose with the Bloomberg Barclays US Aggregate +1.1% and US high yield +0.3%. Cyclical commodities were flat to down on the month.

DELTA VARIANT SURGES THROUGHOUT THE US

The coronavirus Delta variant that has surged overseas through countries like India and the UK has now accelerated here in the US. Daily active new cases have surged to over 100,000 for the first time since February 2021. The surge has been most pronounced in states with the lowest vaccination rates.

In response, governments in areas most affected have reimposed mask mandates, restricted some activities, and reinstated rent moratoriums. Simultaneously, some employers have begun requiring vaccinations to return to in-person work.

Daily New Cases in the United States

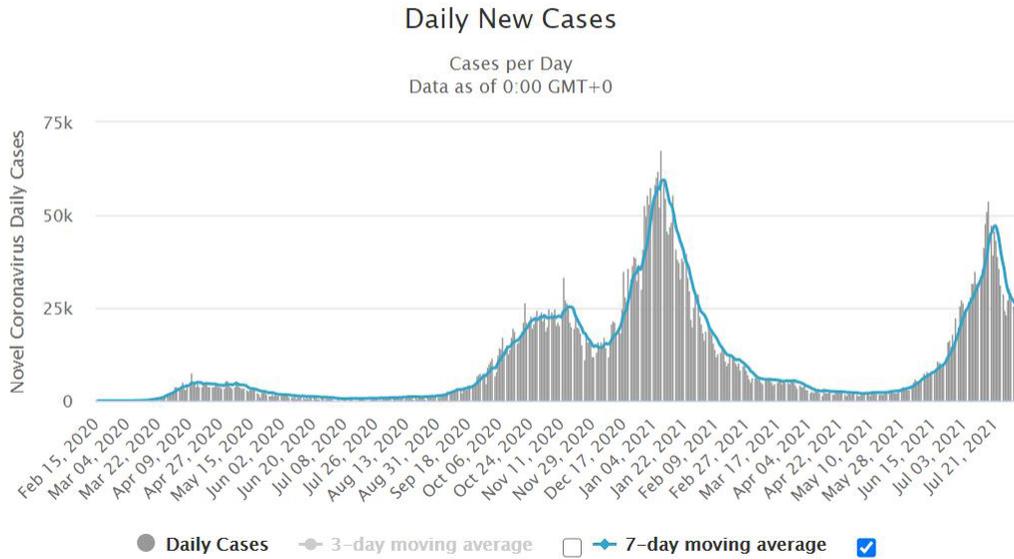


SOURCE: <https://www.worldometers.info/coronavirus/country/us/>

While the varying federal and local guidelines have been confusing for consumers, economic activity continues to march higher with service industries picking up steam. However, rising coronavirus cases are a risk to the economic recovery. The Delta variant is spreading rapidly but if the UK is an example, the infections may also come down as quickly as they rose. As the US surge is a few weeks behind the UK, perhaps the peak is not too far away.



Daily New Cases in the United Kingdom

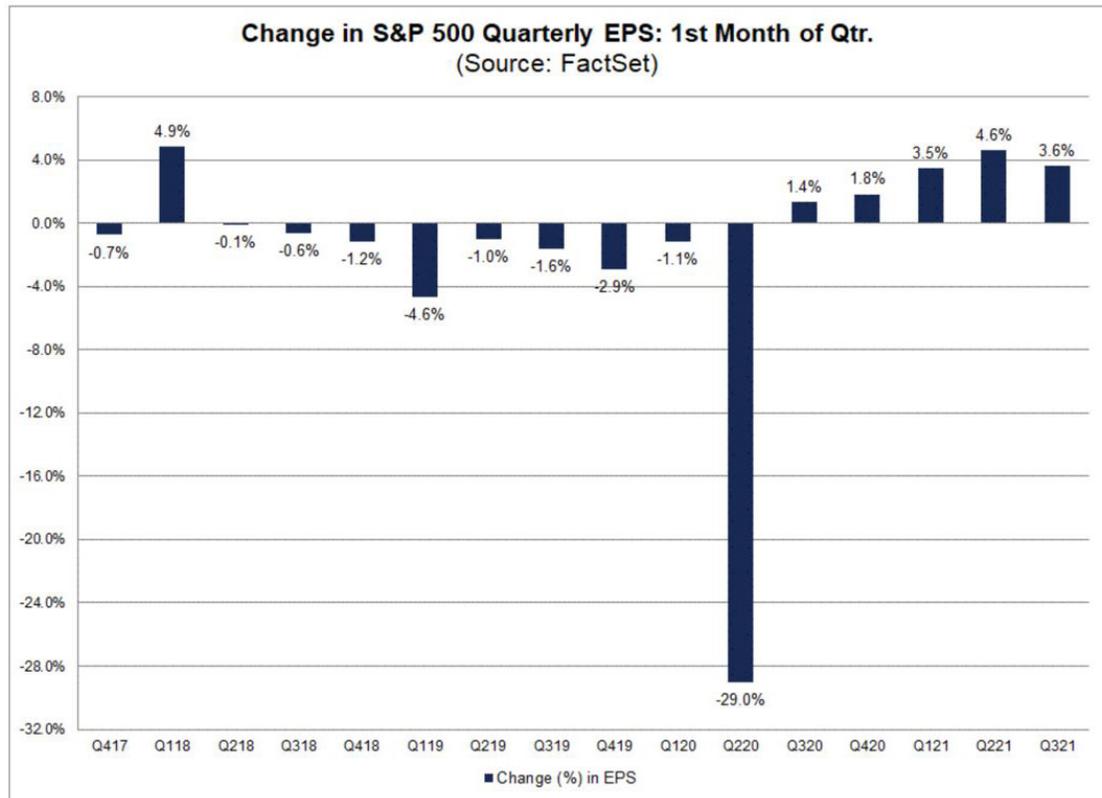


SOURCE: <https://www.worldometers.info/coronavirus/country/uk/>

Q2 CORPORATE EARNINGS POSITIVELY SURPRISE AGAIN

Corporate earnings from the second quarter can be used as a gauge for how companies are recovering from the pandemic. On this metric, the positive surprises continued in Q2. Of companies reporting so far, 88% have reported both positive earnings and revenue surprises. These figures are the best numbers reported since 2008 when Factset started tracking this metric. These positive surprises are driving forward earnings estimates higher for the S&P 500.

On average, earnings are 17% above expectations, led by the consumer discretionary sector with auto and apparel companies doing very well. Financials and communication services were also strong as the economy recovers, led by Google which saw strong earnings relative to expectations. The weakest sectors versus consensus were energy, basic materials, and consumer staples. Input cost pressures are starting to take a bite as margins were squeezed in these industries. Input cost pressures are starting to take a bite as margins were squeezed in these industries. Future price increases may help mitigate the cost pressures, but the timing and magnitude of the price increases have yet to be fully realized.

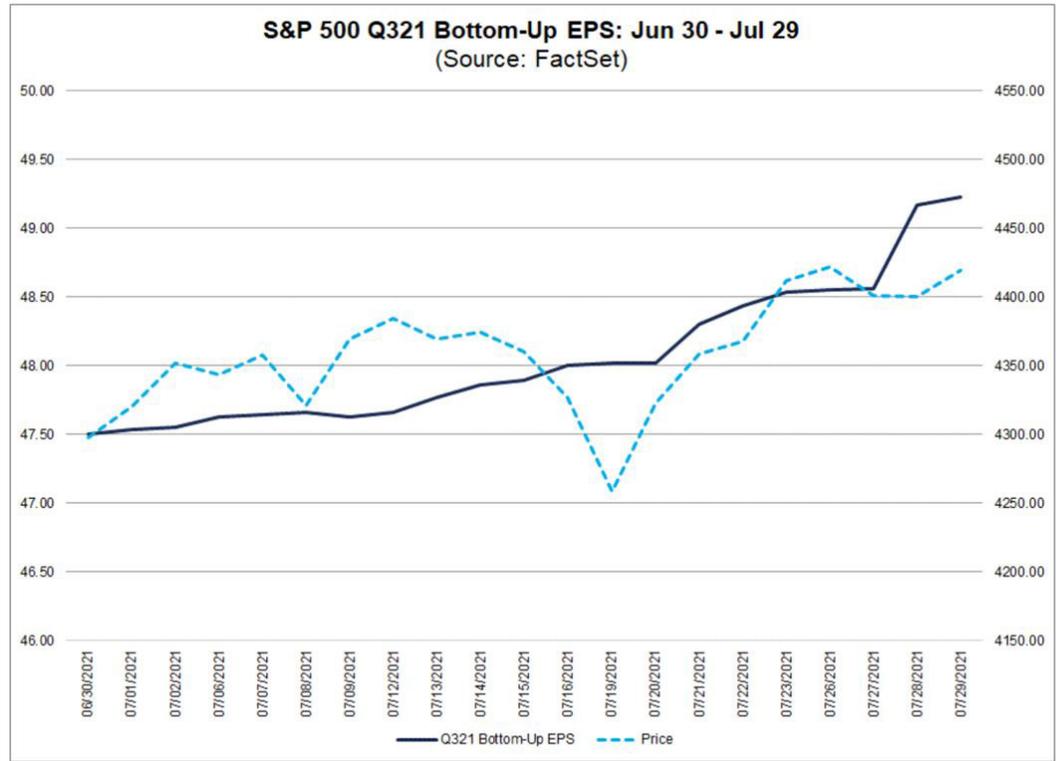


SOURCE: Factset

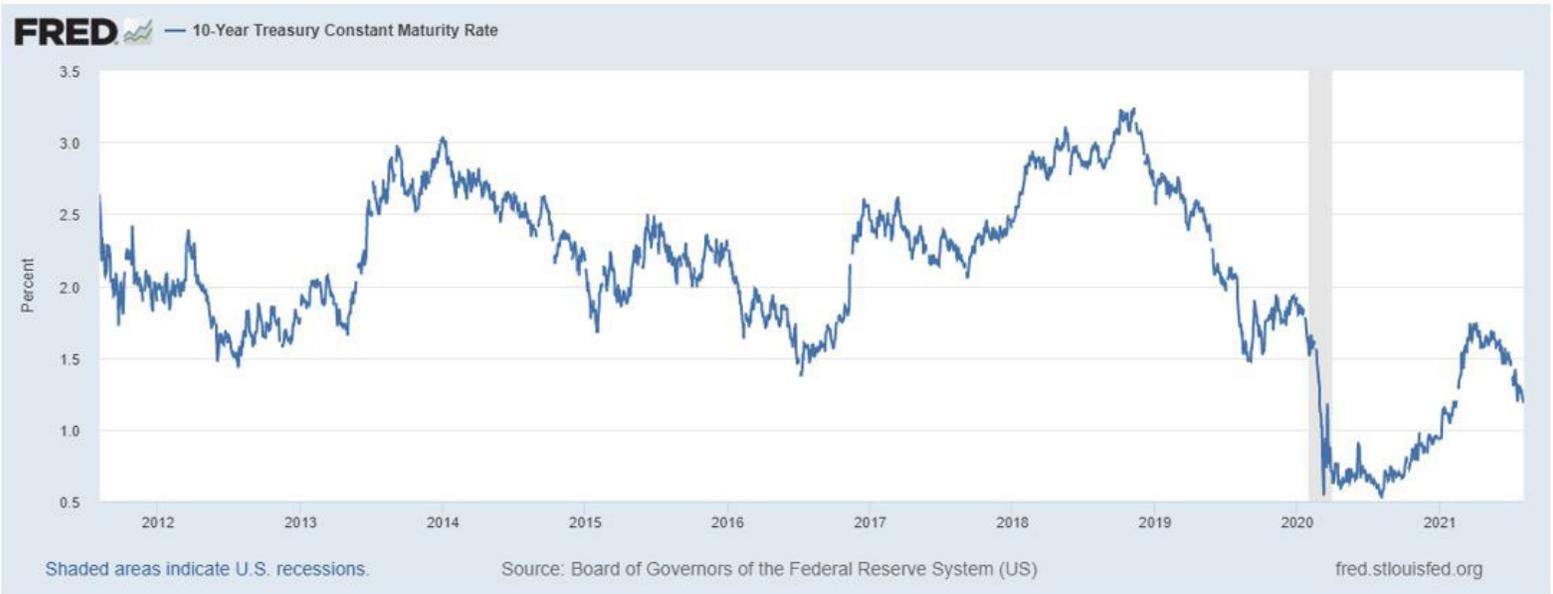


MARKET IMPACTS AS A RESULT OF THE DELTA VARIANT

Equity market reaction followed the earnings surprises in July. In the S&P 500, technology stocks led the way up 4%, while energy lagged down 8%. The more industrial and financials-heavy Russell 2000 fell as cyclical stocks paused with the Delta variant surge. Emerging markets were also down on a combination of weak cyclical stocks and Chinese shares selling off on government crackdowns on various industries. In aggregate for the S&P 500, earnings grew faster than the price of the S&P 500, resulting in valuations becoming more attractive on forward numbers over the last 30 days.



Fixed income markets rallied throughout the month in the flight to safety trade on the rise of the Delta variant. The 10-year US Treasury bond yields continued the march downward that began in April 2021.



SOURCE: <https://fred.stlouisfed.org/series/DGS10>



With persistently lower risk-free interest rates, Pallas Capital has positioned our fixed income portfolios in a barbell high-quality shorter-term debt paired with private credit and real estate for higher yields. The macro drivers to monitor relative to this position would include more fiscal stimulus from the Federal government, the Federal Reserve's stance on accommodative monetary policy, and potential tax increases at the Federal level.

CONCLUSION

The coronavirus Delta variant surges through the US disrupting economic activity and pushing markets into a more defensive mode. Corporate earnings were a bright spot as the positive surprises versus consensus estimates continued. At this writing, the Federal government is debating yet another stimulus package, while the Federal Reserve continues its dovish stance on interest rates. Pallas Capital will continue to monitor macroeconomic, political, and company news for impacts on markets.

Sincerely,



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Pallas Capital Advisors

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