PCA Quarterly Commentary

Q3 2021

Not Yet Transitory Inflation - Q3 2021

September 2021 marked the first time in 226 trading days that the S&P 500 index closed more than 5% below its highs. Interest rates are moving higher as the Federal Reserve discusses the tapering of monetary stimulus and Washington debates the debt ceiling and additional stimulus packages. This Pallas Capital Advisors Q3 2021 commentary 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
Q3 2021	0.6%	-0.2%	-4.4%	-0.7%	-8.1%	0.1%	0.7%
YTD 2021	15.9%	12.7%	12.4%	9.2%	-1.2%	-1.6%	3.8%

SOURCE: Orion

Equity markets were flat to down in Q3 after the negative September move, which was driven by slowing growth and rising interest rates. The economy was impacted by the resurgent coronavirus Delta variant and persistently higher inflation. In the US, the cyclically exposed Russell 2000 small-cap index led the way down at -4.4%. NASDAQ was also down as rising rates dented the valuations of higher price-to-earnings technology stocks. The S&P500 managed a gain of 0.6% for the quarter with consumer cyclicals and healthcare up. Consumer staples and telecommunications lagged.

Emerging markets were the biggest drag in the quarter, down -8.1%. China impacted this asset class the most based on two main factors. The first is the communist government crackdown on capitalist enterprises ranging from the elimination of the for-profit education industry to “encouraging” large technology companies to donate material portions of profit to government causes. The second is concerns around the real estate market sparked by the debt default by a large developer, China Evergrande. The effects of this from a financial contagion standpoint should be confined to China. However, real estate construction may slow as a result, negatively impacting building commodities like iron ore.

Fixed income markets inched higher with high-yield credit performing better than investment grade. The Bloomberg Barclays Agg Index was up 0.1% and the Bloomberg Barclays High Yield Index up 0.7%. The 10-year Treasury rate moved up to 1.53% on September 30th from 1.45% on June 30th. High-yield performed better as the recovering economic data enabled credit spreads to tighten. The market will be watching economic data and Federal Reserve commentary for clues as to when the Fed may begin the tapering of monetary stimulus.

Commodity prices were mixed with oil rallying and gold falling. The oil rebound has been unabated since Q4 2020 with the West Texas Intermediate (WTI) oil price up 2.3% during Q3 to $75 per barrel. Demand is picking up while supply has remained constrained post the pandemic driving prices higher. Gold did not join the rally and was down -1.1% in the quarter. Gold prices historically have performed best when real interest rates are falling, but real rates began to march higher during the quarter.

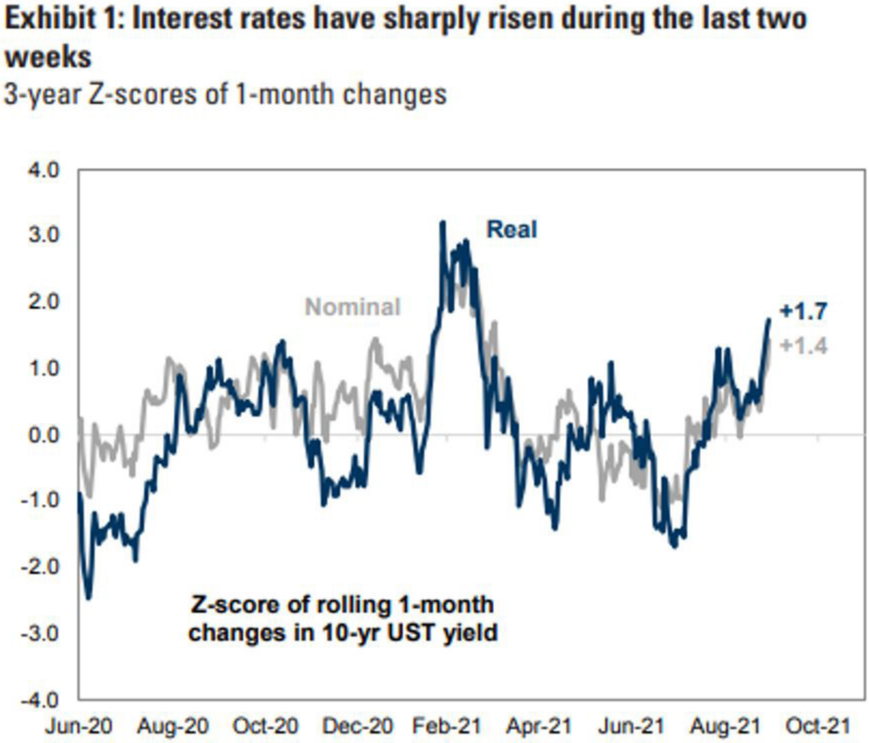
INFLATION, INTEREST RATES, AND THE FEDERAL RESERVE

Inflation for the majority of 2021 has been running higher than the long-run Federal Reserve target of 2.0%. The most recent annualized Consumer Price Index reading was 5.4%.

SOURCE: https://fred.stlouisfed.org/series/CPALTT01USM659N

In September, Federal Reserve Chairman, Jerome Powell, appeared to shift the tone of his comments on inflation and unemployment. In August, he emphasized the weakness in the labor market as reason that the monetary stimulus was still needed despite rising inflation. The inflation numbers were considered temporary given all the disruptions to the economy from the coronavirus – supply chain, labor market, etc. However, in September, Powell's comments were shifted towards inflation being more persistent than originally thought. Both real and nominal interest rates began moving up on the back of this change in tune.

The question remains as to whether the inflation spike is temporary or more sustained. Powell has also explicitly talked about how the tapering of bond purchasing will begin before interest rates are raised. Expectations for the beginning of tapering have now moved forward to the end of 2021.



SOURCE: Goldman Sachs Global Investment Research

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 42% in 2021 and by a further 9% in 2022 to a level of 219. 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.

Exhibit 3: Relative equity valuations remain attractive vs. history

SOURCE: Goldman Sachs Global Investment Research

The earnings yield of the S&P500 is 350 bps higher than the US Treasury yield. Comparisons on valuations to the 1999 tech bubble are sometimes made. However, stocks are still very attractive relative to bonds today. US Treasuries were actually yielding 200 bps more than stocks at the height of the 1999 bubble. On the fixed income front, nominal rates remain low versus history but have begun to trend higher. Credit risk appears to be attractive as the economy recovers while high duration bonds could be hurt if rates move materially higher.

CONCLUSION

Equity markets continue to rally and the economy continues to rebound. The corporate earnings recovery is driving equity markets higher. On the macro front, inflation has exceeded near-term expectations, and the debate continues as to how temporary this inflation will be. Washington is still debating stimulus packages that could lead to more spending and higher taxes. 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