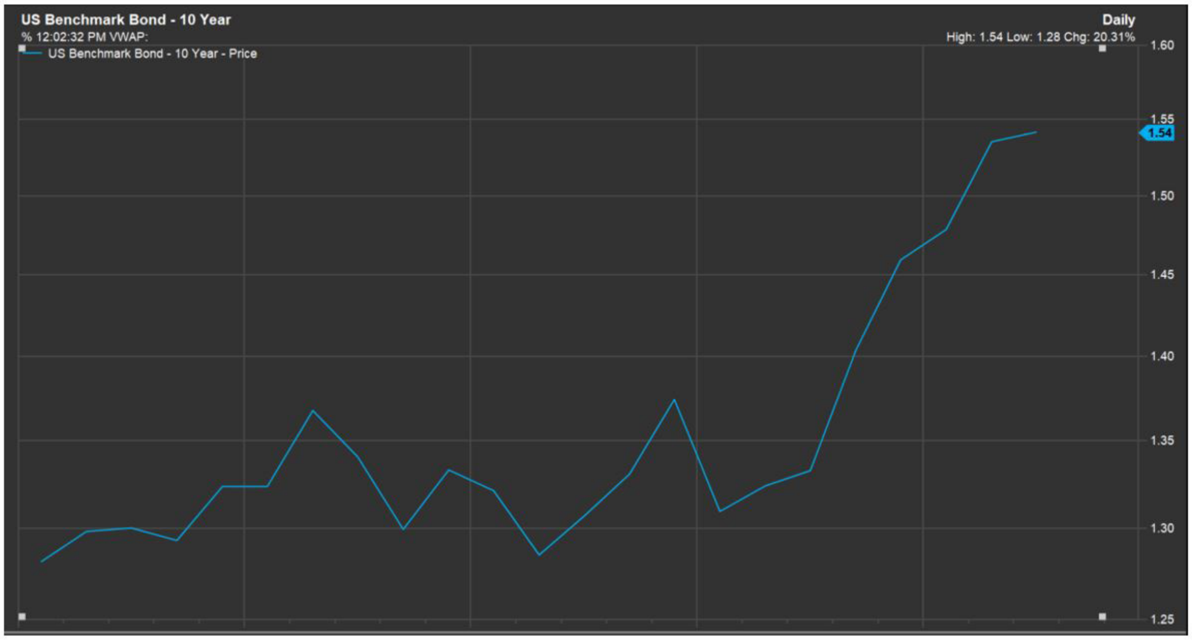
PALLAS
CAPITAL ADVISORS

Week in Review

Friday, October 1st, 2021

1. Fed Tapering Discussion Catalyzes Higher Yields

Over the past week, the yield on the 10-year Treasury bond, the common benchmark yield for long-term investors, notched its biggest gain since the first quarter, moving up by approximately 25 basis points (0.25%).



Source: Factset

This movement in yield followed the Federal Open Market Committee (FOMC) meeting and press conference last week, where Federal Reserve Chairman Powell indicated that the time was approaching to take the foot off the pedal in terms of monetary stimulus. The immediate reaction by the market in terms of treasury yields and equity markets was subdued but gained momentum during this week.

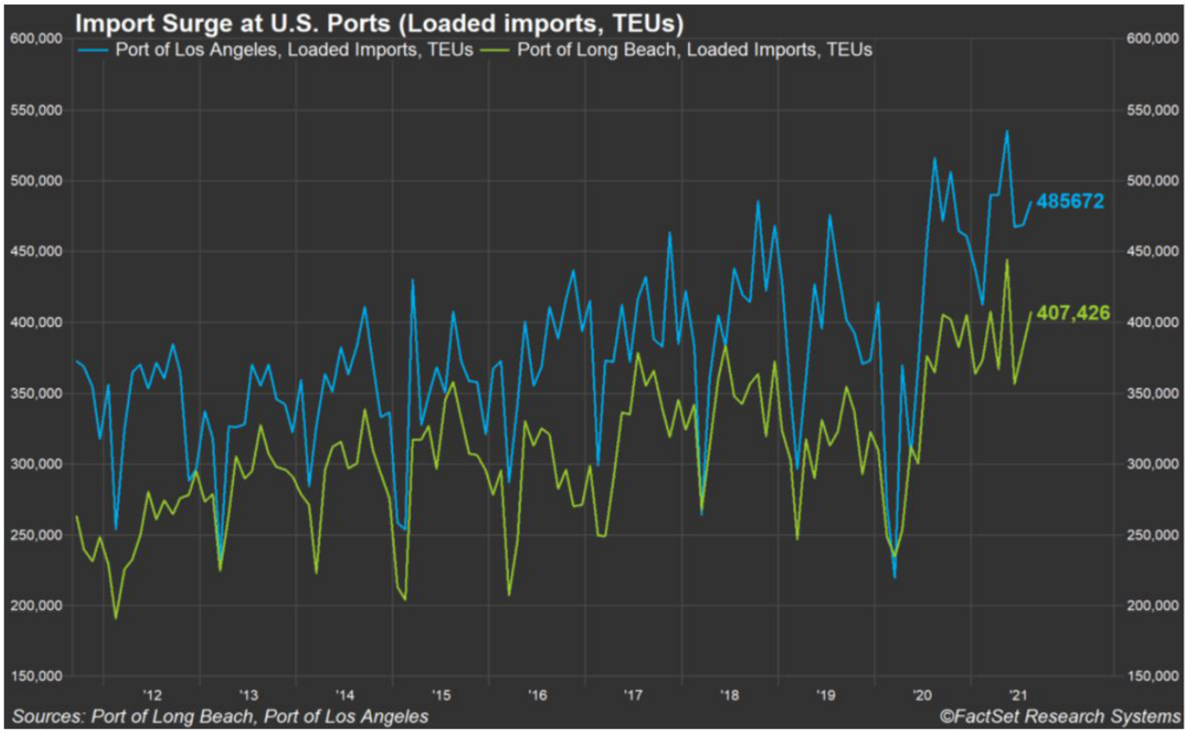
The Fed has a dual mandate to manage both price stability (inflation) and a healthy jobs market (employment) through monetary policy, with one tool being its influence on interest rates. Higher rates support putting the brake on inflation, while lower rates support stimulating growth in the economy and higher employment levels. The Fed set employment gains as a priority coming out of the pandemic. The higher run rate of inflation experienced was seen as temporary, fading as the effects of reopening passed.

The Fed's tone has been changing. Recent Fed commentary has begun to focus on inflation as a more prescient issue. On Wednesday this week, Powell spoke at a discussion hosted by the European Central Bank. In his comments, he said that there are concerns within the Fed that inflation may be more persistent at a higher level which will make managing the process (monetary policy) very challenging over the next couple of years. The movement of higher rates over the last week and the increased volatility in the market are likely linked and echo the challenge the Fed has in managing its dual mandates.

2. Supply Chain Constraints - Demand Outpacing Capacity

Supply chain constraints have been a significant issue following the coronavirus pandemic, impacting the pace of growth and putting upward pressure on pricing. At the core of the issue has been that demand for both raw materials and finished goods has significantly outpaced supply and the capacity of the logistics chain to fulfill the demand.

The large U.S. west coast ports of Los Angeles and Long Beach, which handle a substantial portion of trade with Asia, are a good example of the dilemma. In 2021, the ports have seen a substantial increase in activity level (number of containers processed) over the prior year and well above historical levels.



Source: Factset

While a positive indicator for demand and growth from a historical perspective, the ports have been unable to keep up with the level of demand and a large backlog of ships and containers to unload has built up. The result is a delay in getting some critical parts to manufacturers and fewer finished goods to consumers. The impact is both inflationary as the scarcity of supply relative to demand can push up prices, while at the same time curbing potential growth due to lost sale opportunities.

This situation is not unique to the U.S. ports as congestion has become a global issue. Compounding the issue has been ongoing waves of closures due to new variants of the coronavirus, particularly impacting manufacturing in Asia.

Near-term, supply chain disruptions are having an impact on the operations and financial guidance of companies. Within the last week, Micron Technologies, Sherwin Williams, Nike, and Allegion among others have reduced near-term financial guidance stating supply chain constraints are impacting their cost of goods and their ability to source enough product to meet current demand.

On the positive side, so far demand destruction has not necessarily taken place and the backlogs for many companies are growing. Supply chain disruption and bottlenecks should eventually clear. However, there is a risk, as acknowledged by the Fed, that inflation may be more persistent and higher for longer, at least until supply and demand achieve balance.

3. Markets Finish the Month and Quarter on a Down Note

This week saw the closeout of September and the third quarter of 2021. For the month, September lived up to its reputation as a historically difficult month as it saw the first monthly decline in the S&P 500 since January, declining by 4.8%. Other market indices did little better with the broader Russell 3000 falling 4.5% and the ACWI (All Country World Index) falling by 4.1%.

For the quarter, the S&P 500 finished in positive territory with a 0.6% return, although the broader markets were negative with the Rusell 3000 down slightly (-0.1%) and the ACWI down 1.0%.

The pressures on the markets in September included a myriad of concerns: Fed tapering, legislative discord, supply chain issues catalyzing corporate warnings, the effect of coronavirus resurgence, rising energy costs, and the length of the current market rally. While many of these concerns are causing near-term headwinds to the pace of economic growth, overall economic trends remain favorable for longer-term growth.

Thinking Ahead

A potential change in Fed policy coupled with other factors including slowing growth forecasts, higher energy prices, legislative drama, and supply chain pressures have likely contributed to the rise in volatility and downward pressure on both the equity and fixed income markets. Looking longer-term, the prospects for economic growth remain positive.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.