PCA Monthly Commentary

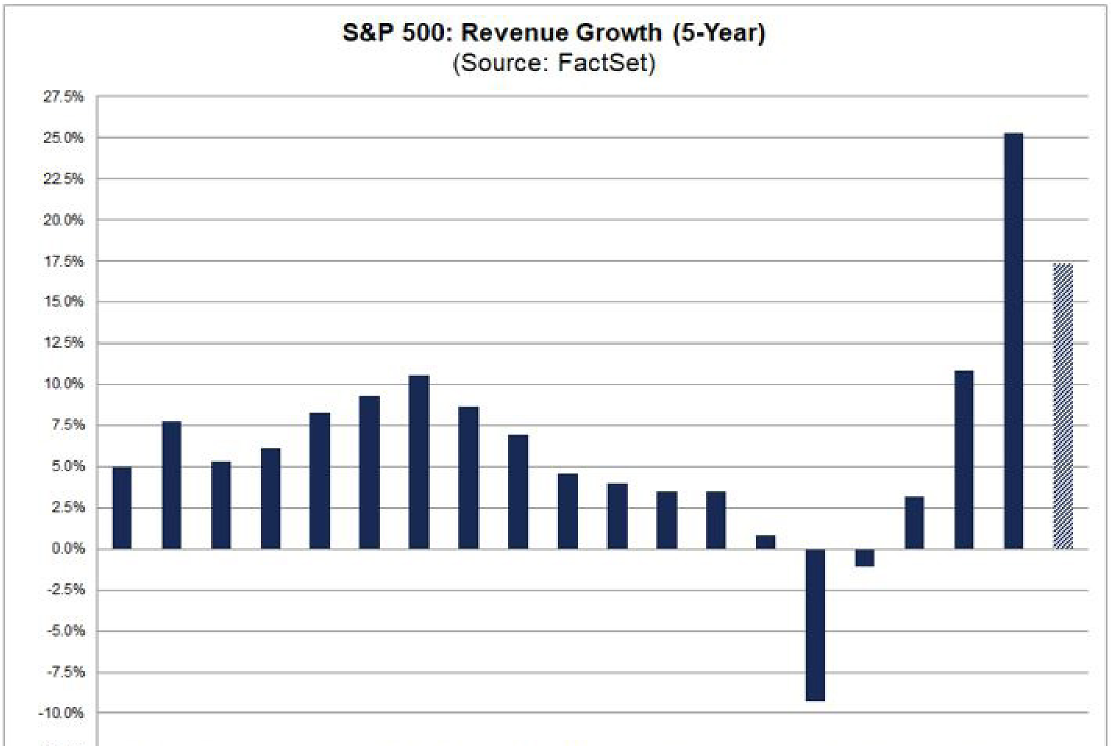
November 2021

Earnings and Inflation Running Hot

Markets rebounded in October 2021 from a down September led by the technology, energy, and consumer cyclical sectors. The Q3 earnings season provided positive surprises versus consensus once again. Inflation readings also came in higher than anticipated. Equity markets were led by NASDAQ +7.3%, with the S&P 500 +7.0%, Russell 2000, +4.3%, EAFE +2.5%, and Emerging Markets +1.0% - all in positive territory. Fixed income performance was flat to down on a muted rate environment with the Bloomberg Barclays US Aggregate unchanged and US high yield -0.3%. Cyclical commodities rallied with oil up 12% on the month.

Q3 CORPORATE EARNINGS POSITIVELY SURPRISE AGAIN

Third-quarter corporate earnings season surprised to the upside again. According to Factset, the S&P500 is reporting the second highest revenue growth since at least 2008 at 17.3%. Sectors reporting strong growth include energy, consumer services, and technology.



	Q416	Q117	Q217	Q317	Q417	Q118	Q218	Q318	Q418	Q119	Q219	Q319	Q419	Q120	Q220	Q320	Q420	Q121	Q221	Q321
■ Growth	5.0%	7.7%	5.3%	6.1%	8.3%	9.3%	10.5%	8.6%	6.9%	4.6%	4.0%	3.5%	3.4%	0.8%	-9.3%	-1.1%	3.2%	10.9%	25.3%	17.3%

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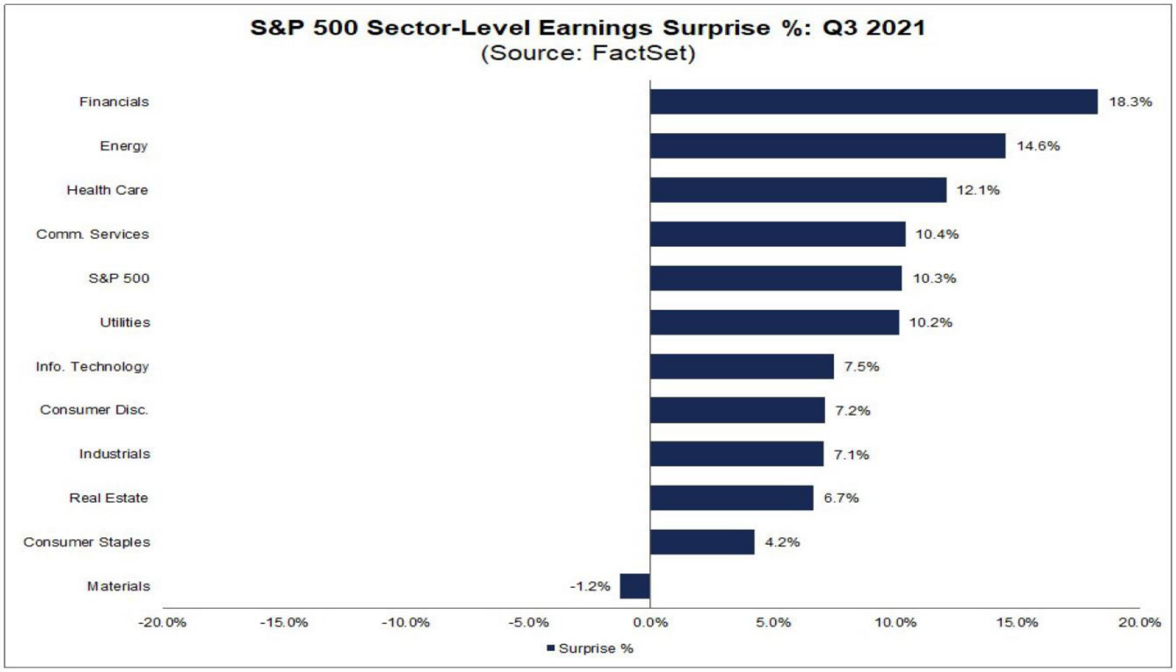
Rising oil prices drove the energy sector revenue higher. Revenue from cruise lines, restaurants, and other consumer services was propelled by the economic reopening. Finally, technology revenue maintained a strong pace with the likes of Microsoft and Google reporting excellent results.

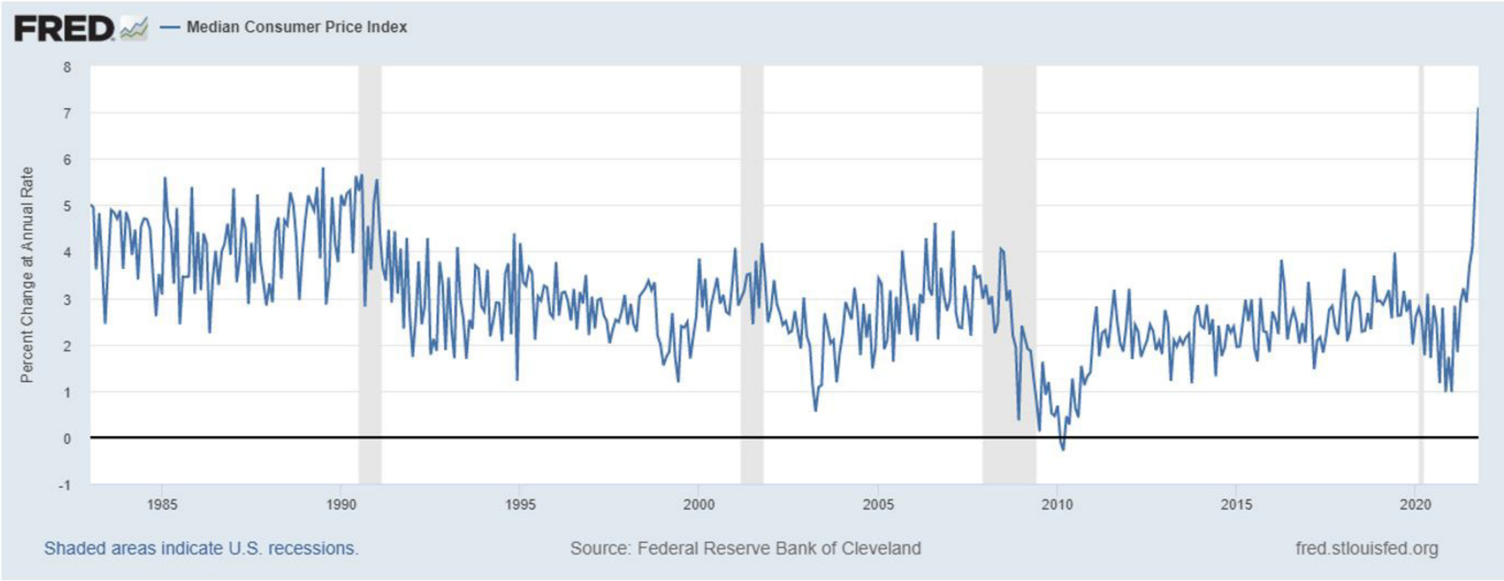


The revenue surprises also led to very positive earnings surprises in the quarter. Of companies reporting thus far, 81% have reported positive earnings surprises. The 81% for the quarter would mark a tie with Q2 2018 for the fourth-highest percentage of S&P 500 companies reporting a positive earnings surprise since FactSet began tracking this metric in 2008. The current record is 87%, which occurred in Q2 2021. Sector level earnings surprises were led by financials, energy, and healthcare.

The weakest sectors versus consensus were basic materials and consumer staples. 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.

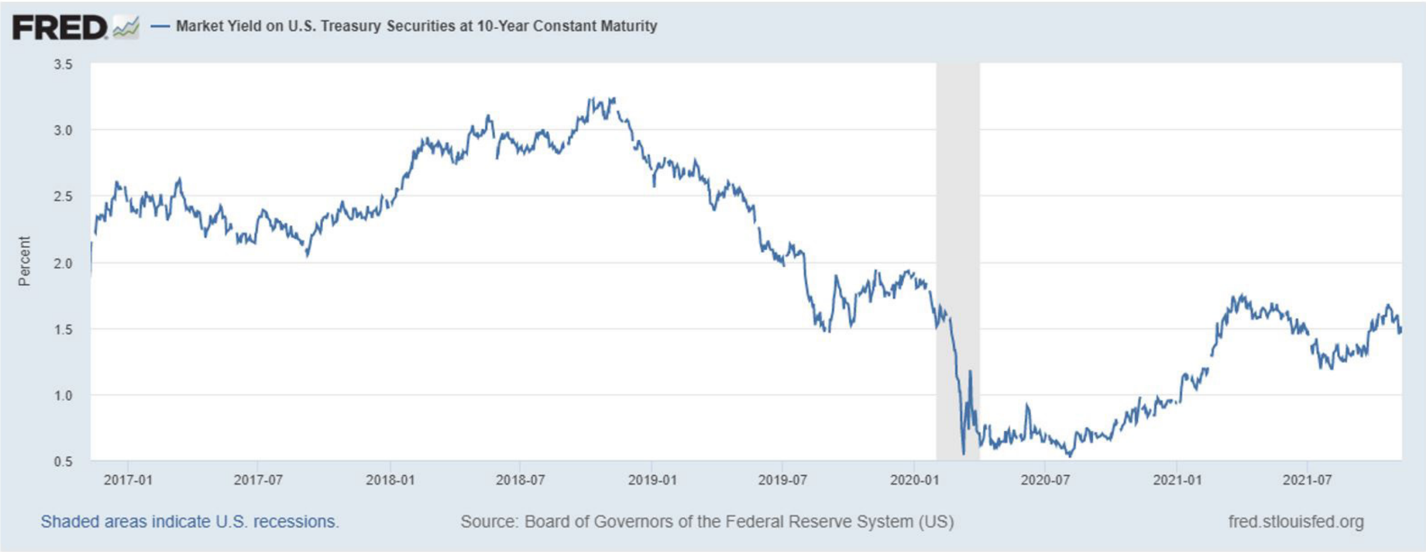
INFLATION RUNNING HOT

Inflation also surprised to the upside this month. The consumer price index (CPI) just recorded a 30 year high at 7.1%.



Over the last month, the Federal Reserve commentary shifted from waiting to begin tapering quantitative easing to beginning the taper. Markets generally took this as a positive sign that the Federal Reserve was not too far behind the curve. The recent spike in CPI has reignited the debate around if the Fed will need to accelerate the timetable for raising rates, which is currently predicted to be in late 2022. A more hawkish Fed could slow the economy faster than anticipated if this level of inflation persists.

The bond market has sent interesting signals amid strong earnings and rising inflation. The 10-year Treasury yield has remained relatively steady and stands at 1.55%.



The bond market appears to be highlighting a longer-term concern regarding slowing growth. The theory would be that the economic recovery from the pandemic will slow, and if inflation remains elevated, the Fed will be forced to raise rates and thus slow the economy.

CONCLUSION

The corporate earnings positive surprise string continued in Q3 with very strong numbers. Inflation is also running hot as the CPI hit a 30 year high. Against this backdrop, long-term US Treasury yields remained relatively steady suggesting an economic slowdown could be in the future. Pallas Capital will continue to monitor macroeconomic, political, and company news for impacts on markets.

Sincerely,

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