PALLAS
CAPITAL ADVISORS

PCA Quarterly Commentary

Q4 2021

Strong Finish to 2021, Outlook for 2022 – Q4 2021

US equity markets demonstrated strong returns in Q4 2021, while interest rates were broadly stable. As 2022 begins, interest rates are moving higher as the Federal Reserve discusses a faster tapering of monetary stimulus. The Omicron coronavirus variant rages through the US impacting many aspects of the economy. This Pallas Capital Advisors Q4 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
Q4 2021	11.0%	8.4%	2.1%	3.2%	-1.2%	0.0%	0.7%
2021	28.7%	22.2%	14.8%	13.2%	-2.2%	-1.5%	4.5%

Source: Orion

US equity markets finished 2021 on a strong note with the S&P500 leading the way up +11.0%. Corporate earnings' fundamentals continued to be strong as companies have thus far been able to manage any inflationary pressures. Leading sectors included consumer cyclicals and technology. Telecommunications lagged due to stock-specific issues. NASDAQ was also up 8.4% led by technology stocks, while the small-cap Russell 2000 brought up the rear, up only +2.1%.

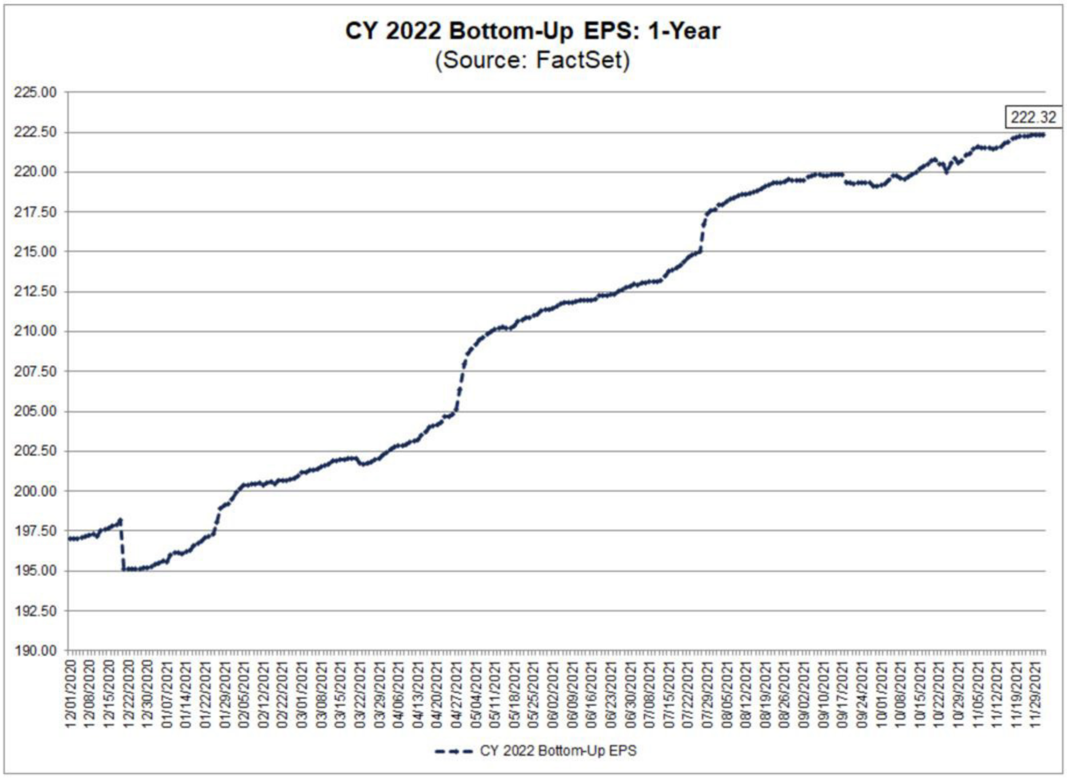
Emerging markets were the biggest drag in the quarter, down -1.2%. The lingering effects of the coronavirus continue to weigh on global economic activity, impacting the more cyclical emerging markets. China is also still battling real estate defaults as well as corporate governance issues, especially in the technology sector. International developed markets fared better, up +3.2%. These markets do not have the Chinese corporate governance or real estate issues, but international developed markets have more exposure to cyclical industries which have been negatively affected by the surge of Omicron.

Fixed income markets were broadly stable with high yield credit performing a bit better than investment grade. The Bloomberg Barclays Agg Index was flat and the Bloomberg Barclays High Yield Index was up 0.7%. The 10-year Treasury rate moved up to a high of 1.78% on January 10th from 1.51% on December 31st. A 0.27% move in Treasuries over 10 days was attributed to more hawkish commentary out of the Federal Reserve regarding tightening monetary policy at a faster pace. High yield performed better as the recovering economic data enabled credit spreads to tighten.

Commodity prices rose modestly on the quarter. Oil held the gains from earlier in the year as the economy continued to recover, while increasing fears around coronavirus limited travel demand. The West Texas Intermediate (WTI) oil price was up 1.3% during Q4 to $76 per barrel. Gold rallied in Q4 +3.9%, mitigating the loss for 2021 to -4.3%. Gold prices historically have performed best when real interest rates are falling, but real rates began to march higher during the year.

Earnings Drive Stocks in the Long Run

Pallas Capital Advisors (PCA) believes that earnings drive stocks over the long run. PCA capital markets assumptions are constructed on the back of our long-run earnings forecasts. Equity markets in 2021 were fueled by earnings as the S&P500 price to earnings multiple actually declined by over 5% during the year. 2022 earnings forecasts have risen to 222, and 2023 is up to 245, per Factset.



https://insight.factset.com/industry-analysts-expect-sp-500-to-report-record-high-eps-in-2022

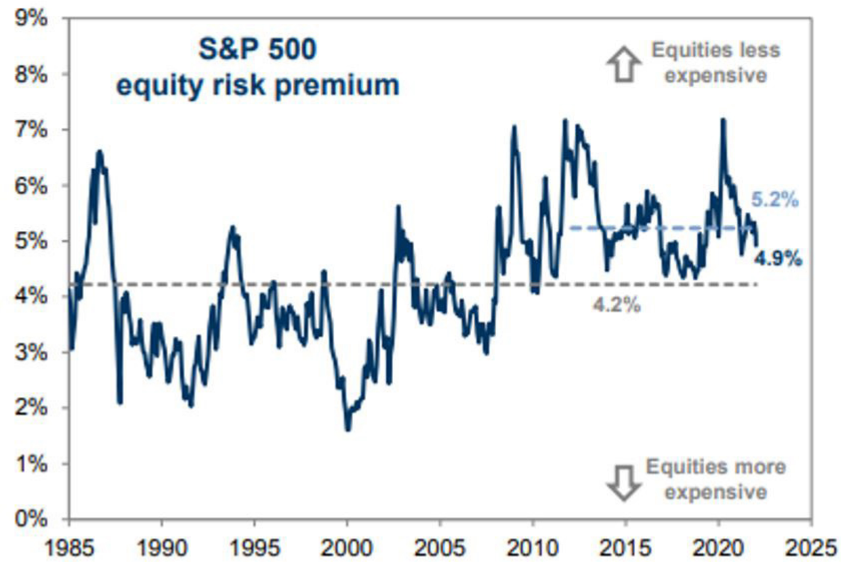
Earnings growth drives stocks which can be seen in the graphic below. The fastest-growing quintile of companies over a 5-year rolling period have averaged a 17% return while the lowest quintile actually declined by -1%. PCA equities are positioned in quality companies with a strong 5-year earnings outlook.

Source: Jennison and FactSet. [2]Data range for rolling periods: 1/1/1997–12/31/2020. [3]Data as of 9/30/2020. Most recent available.

Equity Market Valuations Reasonable Given Level of Interest Rates

The S&P500 price to earnings ratio on 2023 earnings is 19x's which is higher than long term averages but lower than the over 20x's of the last few years. One way to measure value is through the equity risk premium. The equity risk premium is measured by the earnings yield of the S&P500 minus the risk-free rate. Given the low interest rate environment, the equity risk premium of 4.9% is still attractive versus history.

Exhibit 2: The S&P 500 ERP remains above the 35-year average



Source: Goldman Sachs Global Investment Research

PCA base case is for long term Treasury rates to drift up over the course of the year. The sensitivity table below displays various appropriate P/E ratios given the equity risk premium and 10 year Treasury.

Exhibit 3: S&P 500 dividend discount model-implied P/E multiple based on Treasury yield and ERP

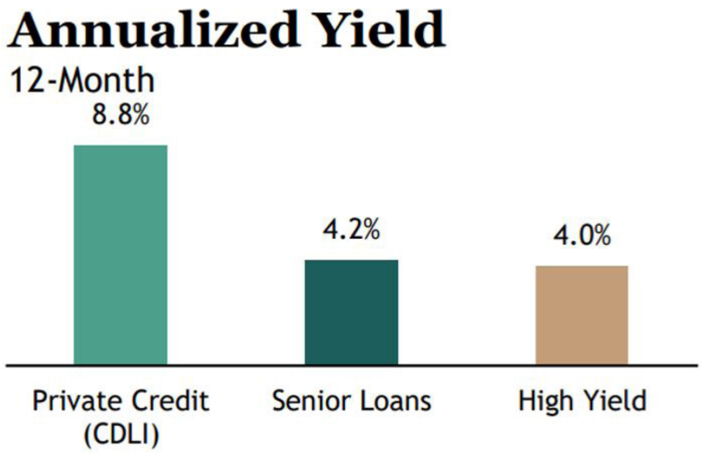
Implied S&P 500 NTM P/E at year-end 2022

Equity Risk Premium		10-year US Treasury yield: 1.50 %	1.75 %	2.00 %	2.25 %	2.50 %
Long-term median	4.2 %	29 x	27 x	25 x	23 x	21 x
YE 2022E	4.6 %	26	24	22	20	19
Current	4.9 %	23	21	20	18	17
10-year median	5.3 %	20	19	18	17	15
	5.6 %	19	17	16	15	14

Source: Goldman Sachs Global Investment Research

Low and Rising Treasury Rates Necessitate Move to Private Markets for Yield

Given the very low risk-free interest rate environment, PCA endeavors to invest in higher-yielding securities as a piece of the allocation. PCA runs a barbell process of roughly half of the portfolio in high-grade public, low-yielding debt paired with higher-yielding, higher credit risk private debt. For example, for a comparable credit risk, the private markets are yielding 8.8% while the public market's high yield rate is 4.0%. Private credit yields more than 2x's public markets at current rates (which are subject to change).



Source: Morningstar, Cliffwater Direct Lending Index, S&P/LSTA Leveraged Loan Index.

CONCLUSION

2021 was a very strong year in US equity markets driven by earnings growth. As the calendar turns to 2022, earnings growth is poised to slow but still be positive. The Federal Reserve has signaled that monetary policy may tighten further. With the low level of public interest rates, private credit markets can provide higher income for a comparable credit risk. Corporate earnings season is about to begin which will be monitored closely for any changes in trends. Pallas Capital will be vigilant in tracking the pandemic, taxes, stimulus, corporate earnings etc. and their impacts on markets.

Sincerely,

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