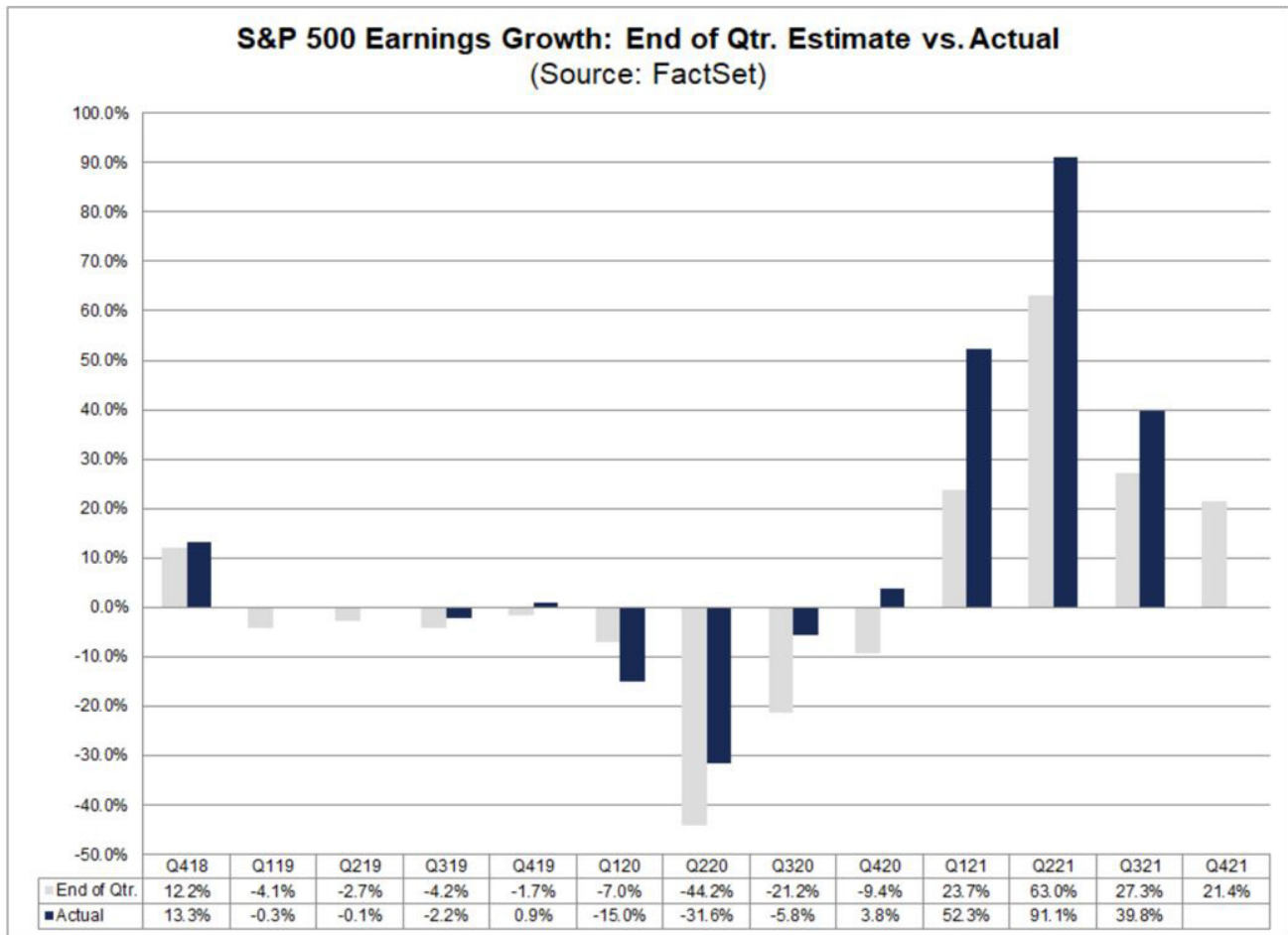


WEEK IN REVIEW

FRIDAY, JANUARY 21ST, 2022

1. EARNINGS GROWTH CONTINUES AS INTEREST RATES ARE SET TO RISE

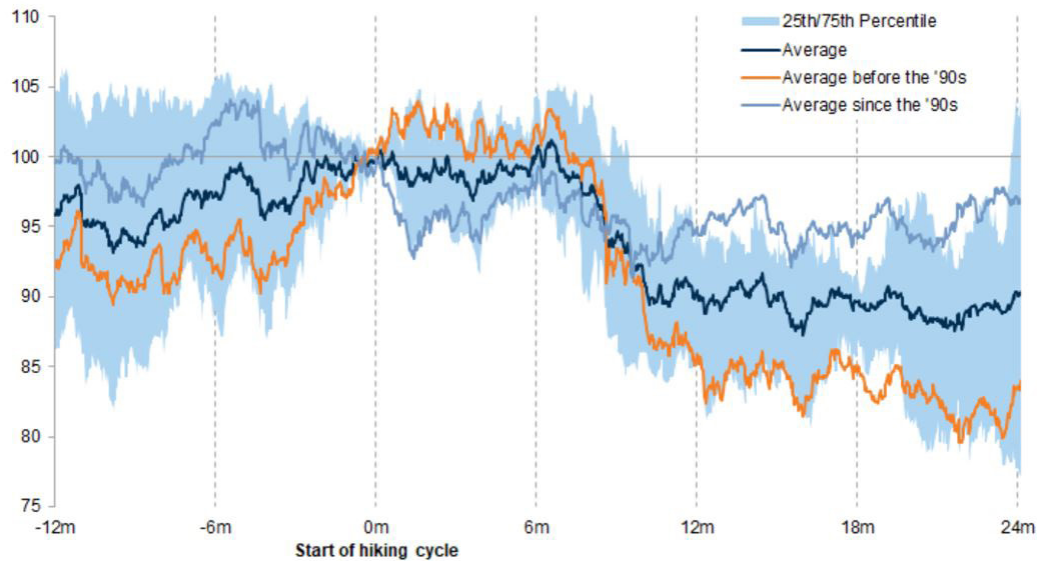
Earnings for the fourth quarter have started and estimates suggest that it will mark the fourth straight quarter of growth of more than 25% for the S&P 500.



While current estimates are for 21.4% growth, on average over the past five years the actual rate of growth has increased due to the number and magnitude of positive earnings surprises. Based on companies that have reported so far, upward revisions once again are upwardly biased and should result in growth over 25%.

As the Federal Reserve moves closer to embarking on the raising of rates, earnings growth will be particularly important for equity returns. Historically, valuation multiples have compressed with the commencement Fed rate hikes, and that compression needs to be offset by earnings growth.

S&P 500 12 month forward P/E ratios around to start of Fed rate hike cycles (trailing P/E before 1985)

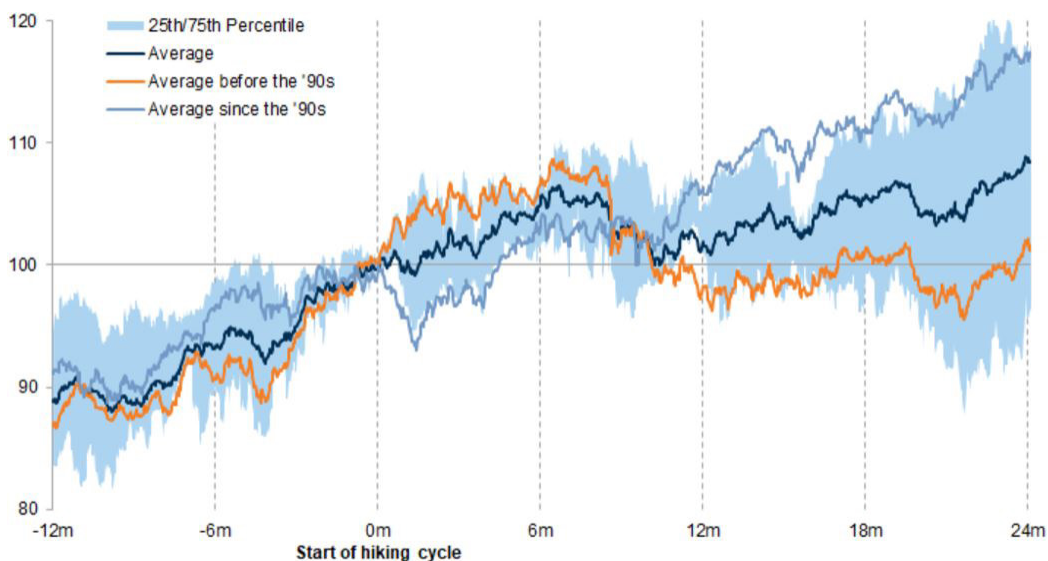


Source: Datastream, Bloomberg, Goldman Sachs Global Investment Research

On average, the level of compression has been 10% with the statistical range being symmetrical from 0% to -20%. More recent data points have tended toward the lower level of compression.

However, despite the compression of valuation multiples, the market has generally held up better than the multiple compression as earnings growth has offset and, in many cases, exceeded the level of valuation from multiple compressions, resulting in flattish to positive levels of overall market return.

S&P 500 around the start of Fed rate hike cycle since 1970 (indexed to 100)



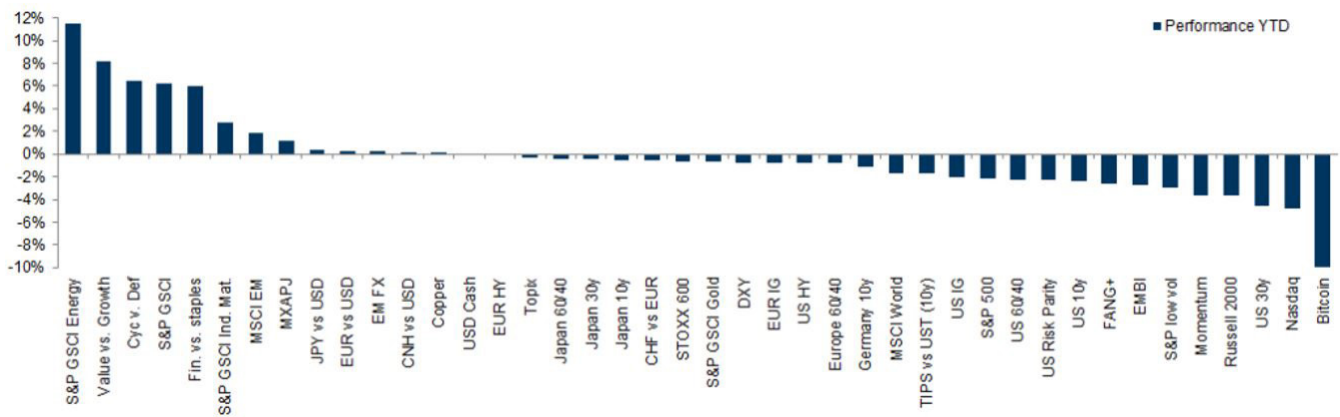
Source: Bloomberg, Goldman Sachs Global Investment Research

As companies report this quarter and provide their guidance, the trajectory of those earnings coupled with more conservative multiples will likely be the determinant of the trajectory of their own stock prices and in aggregate the direction of the market.

2. EQUITY MARKETS UNDERGOING TYPICAL RISING RATE SCENARIO

Year to date, the market has seen a rotation among asset categories with energy and value stocks benefiting and more speculative, longer duration business models, such as development stage biotech and unprofitable and high valuation multiple stocks, under pressure.

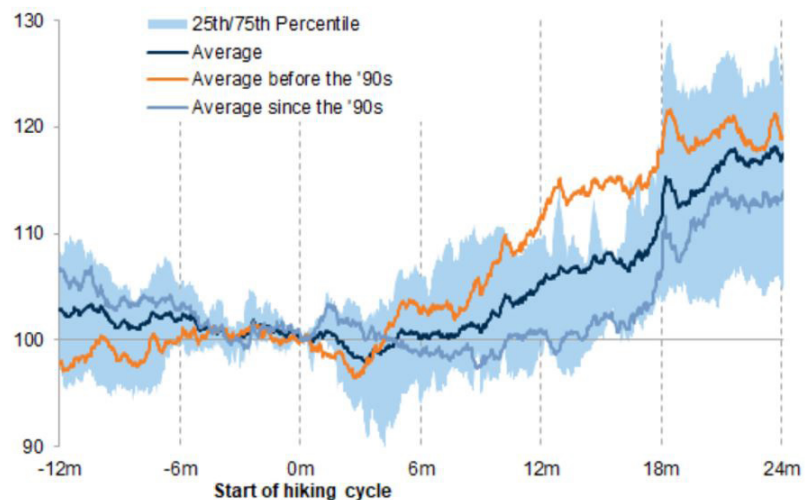
Total return, local currency



Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

This outcome is consistent with historical periods when the Federal Reserve is embarking on rate increases. Historically, rate increases have come during periods of economic growth and inflation which have benefited the fundamentals for value-oriented business such as cyclicals, financials, and commodities such as energy. In addition, value-oriented sectors have had less of a headwind in terms of multiple compression as they have typically entered the rate cycle at a lower level relative to growth. The combination of these factors being positive for their absolute and relative performance.

US value vs growth around the start of Fed rate hike cycle since 1970 (indexed to 100)



Source: Datastream, Kenneth French, Goldman Sachs Global Investment Research

However, much of the outperformance by value has been realized early in the transition to higher rates and in the more recent past, the outperformance has often been very short lived. Ultimately, long-term earnings growth and reasonable expectation reflected in valuation multiples have been the key determinants in long-term relative performance among equities.

THINKING AHEAD

The year has started off with increased volatility as rapid rotation has been underway to adjust for a rising rate environment in part as a response to elevated inflation. So far, the movements have been consistent with historical patterns. History would also suggest that focusing on investments with strong long-term fundamentals and reasonable valuations will ride out such periods of transition.

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

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