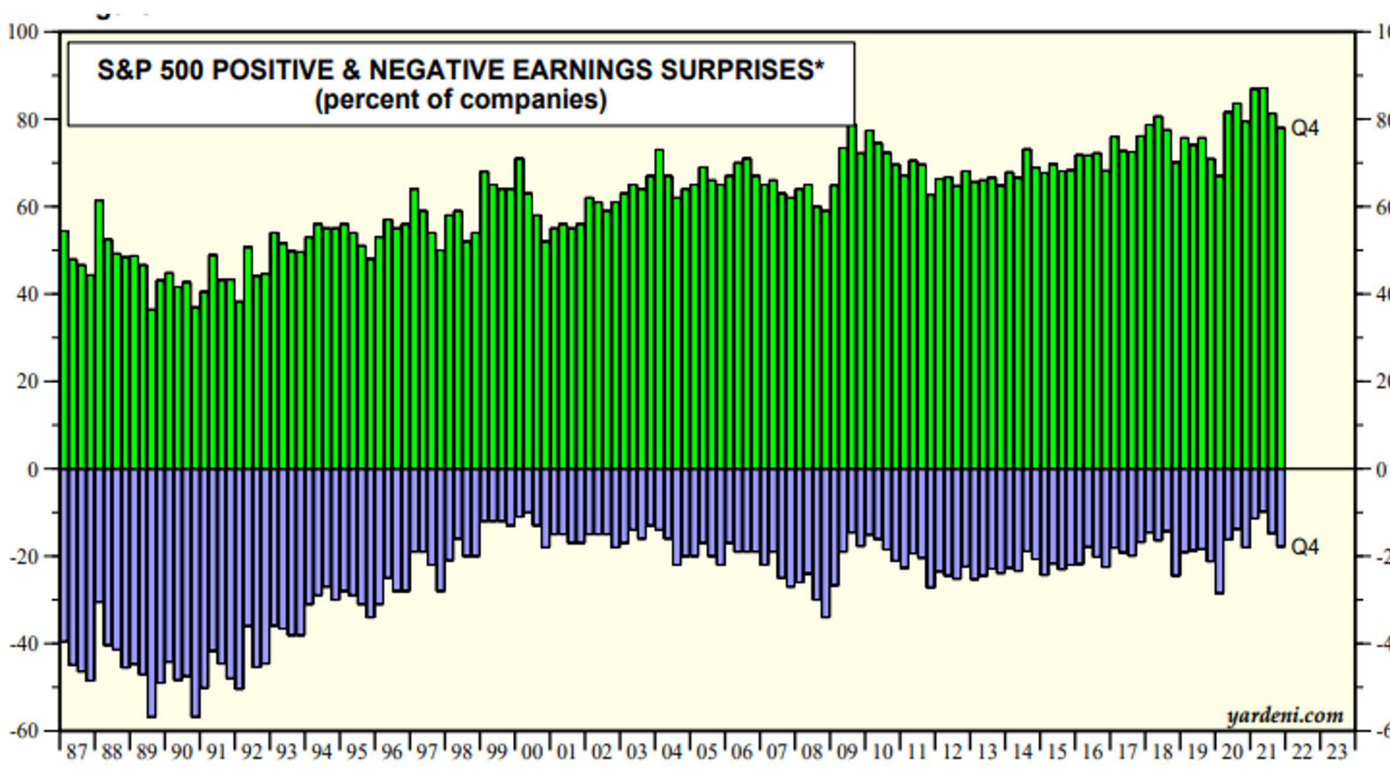
Week in Review

Friday, February 4th, 2022

1. Earnings Season Tracking Normal Despite Wild Volatility

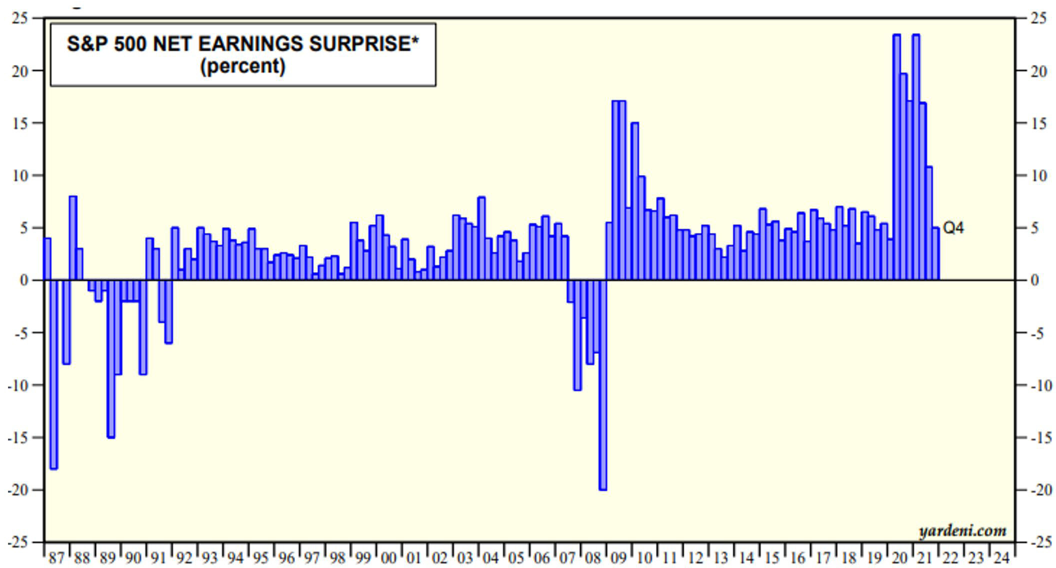
The earnings season is well underway with many of the largest companies already reporting. An important measure for gauging the initial stock reaction of a company's stock price following their earnings release is how the reported quarter came in relative to expectations. The thought process is that the current share price reflects the current expectations for the company and that exceeding expectations can see a positive rerating.

Just over 77% of reporters this earnings season have exceeded consensus EPS estimates. On the surface, this is positive and largely in line with the five-year average. However, it is below the recent experience of the last four quarters which averaged 84%.



* Percentage of S&P 500 companies that reported earnings above or below the consensus estimate at the time of the earnings report.
Source: I/B/E/S data by Refinitiv and Yardeni Research Inc.

Also important is the magnitude of the earnings revisions. In aggregate, companies have reported earnings 4.8% above expectations. While in line with the long-term averages, the rate is well below the latest four-quarter surprise rate of 15.7%.



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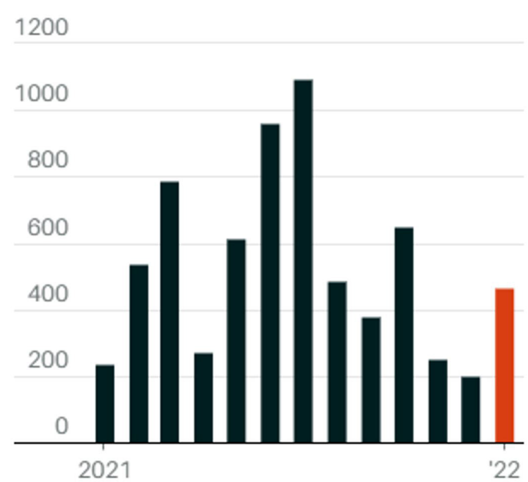
Earnings surprise capped at -20% during Q4-2008.
Source: I/B/E/S data by Refinitiv and Yardeni Research Inc.

The softer beat rates, while not unexpected, continue to play into concerns about slower growth and peak margins. While companies continue to highlight a favorable demand backdrop, the lapping of the height of pandemic closures and business disruption, ongoing supply chain disruption, and input price pressures continue to dominate the broader earnings narrative and are expected to persist over at least the next few quarters. Weaker guidance trends, albeit still above expectations in many cases, are starting to get more attention.

2. January Jobs Report Surprises to the Upside

Omicron, bad weather, and the post-holiday season were expected to slow job growth. However, jobs in January came in at 467,000 which is well up from December's print of 199,000. In addition to job growth, the labor force participation rate increased, and wages grew at a strong rate.

Monthly Jobs Growth



Note: Seasonally adjusted.
Source: Labor Department.

The surprise and positive momentum for job growth is a positive indicator for the US economy. The US economy is ultimately driven by consumer spending and a strong employment backdrop is important to support spending.

Job growth remains an important statistic for the Federal Reserve. The latest data is likely supportive of the current position for liftoff of rates in March. Chairman Powell said that the final decision will be data-dependent and the strong January data will likely be viewed as a factor in terms of pace and magnitude of tightening policy. This may place some further pressure on high valuation multiples as the risk-free rate of return adjusts upward. Ultimately, we believe that earnings growth supported by a strong labor market is a net positive for the equity markets with a longer-term horizon.

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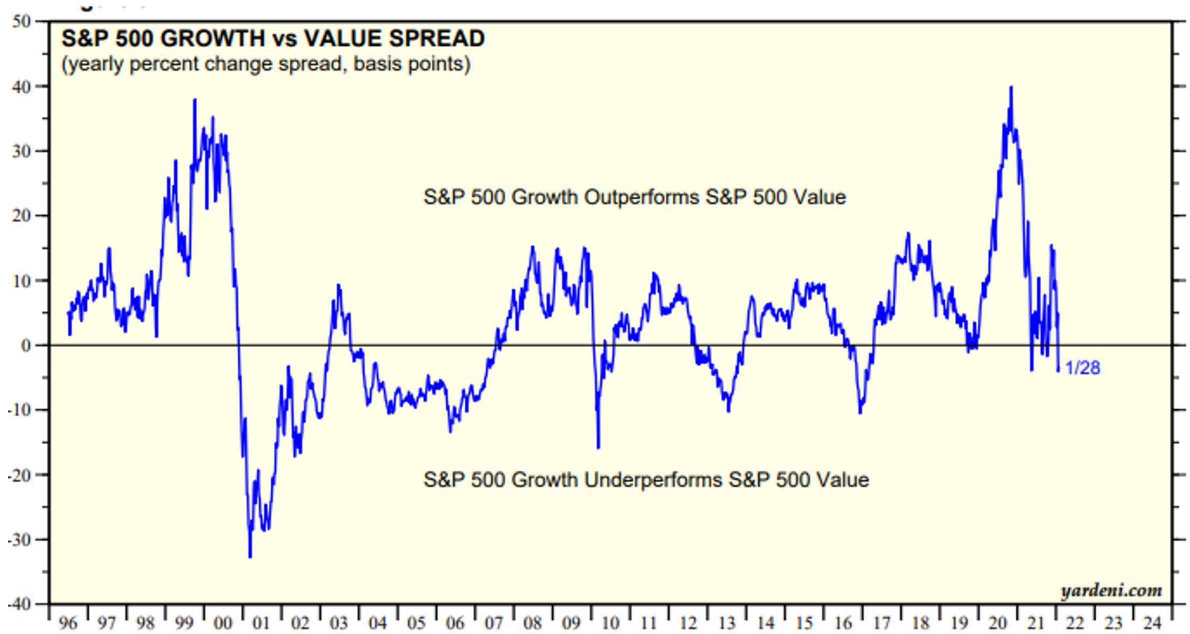
3. Value Stocks Have Recently Been Performing Better

A common topic in the equity markets this year has been the outperformance of value stocks versus growth stocks. Value stocks tend to be focused on more asset-intensive, lower growth, lower ROE (return on equity) businesses such as banks, insurance, oil and gas, industrial, materials mature pharma, and utilities. Growth, on the other hand, tends to focus on the faster-growing companies and include technology, consumer discretionary, small bio-tech, and other emerging businesses.

Both growth and value companies can be suitable holdings in a well-diversified equity portfolio. Performance, however, has been strongly skewed to growth stocks since 2016 with outperformance by growth peaking during 2020 and 2021.



Source: Standard & Poor's and Haver Analytics.

The recent pullback in higher multiple growth stocks and outperformance in value-oriented businesses such as traditional banks and oil and gas has seen recent relative performance move towards value stocks. The current environment of rising rates, higher oil prices, and the contraction of valuation multiples are likely supportive of this adjustment. However, it is also possible that a significant portion of the performance delta has been realized based on the history of the past 20-years.

Pallas Capital Advisors believes high quality businesses with drivers for sustainable growth and acquired at disciplined valuation levels will perform well over time.

4. Shifting Patterns Expected in Consumer Spending

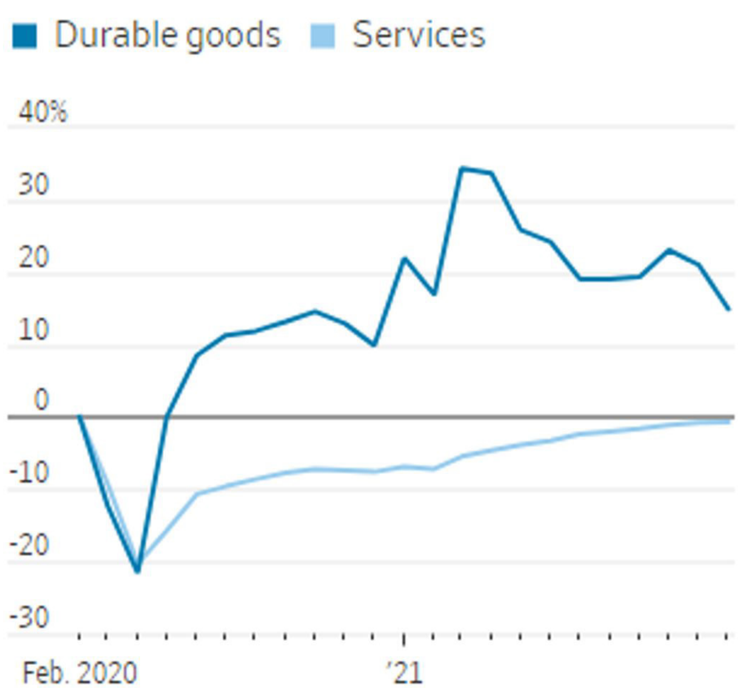
The strength in employment and wage growth suggests that the US consumer is in good shape. This bodes well for consumer spending, but a shift in spending patterns from goods to services may be in the cards. Consumers have different options for spending. On one end are goods that consumers depend upon no matter the economic environment. These are known as consumer staples such as food, medicine, gasoline, and cleaning products. These were beneficiaries in the initial months of the COVID pandemic when the economy was contracting.

The next stage of strong consumer spending as the economy recovered was consumer durables. Consumer durables include spending on items such as cars, furniture, appliances, and home improvement. Consumer durable spending was aided by low-interest rates, government stimulus, deferred spending, and the stay-at-home oriented phase of the recovery.

The next phase of recovery is expected to be consumer discretionary and services. This includes areas of spending such as travel, entertainment, and restaurants. During COVID and continuing with the Omicron variant, spending has been depressed in these areas. However, consumer discretionary spending has been gaining momentum even as consumer durable spending has started to fade.

It is likely that this change in momentum will continue. For example, airlines are substantially increasing airfares a couple months out from where they currently stand, and hotels are increasing room rates as well. These yield management measures are being undertaken on the expectation for pent up demand to materialize. This does have implications for equities and potentially the broader economy as the spending shift may favor the fundamentals for consumer services, while at the same time taking some pressure off consumer goods demand. This should benefit supply chain bottlenecks and inflationary input costs.

Consumer spending on goods and services, change from February 2020, adjusted for inflation



Note: Seasonally adjusted.

Source: Commerce Department, Wall Street Journal

Thinking Ahead

Heightened volatility has continued in the investment markets as the pace of growth of the economy and individual businesses grapple with the potential pace of rising interest rates. Short-term, there is an overlay of good news is bad news regarding the markets as rates are set to rise. Longer-term, positive fundamentals for the markets and individual companies are likely to prevail. Identifying businesses to benefit from positive long-term fundamental trends will continue to be a focus.

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