PALLAS
CAPITAL ADVISORS

Week in Review

Friday, March 25th, 2022

1. Market Resiliency One Month After the Invasion of Ukraine

We are now one month post the Russian invasion of Ukraine on February 24. The anticipation and event caused a major disruption to global markets. While the war has had a real impact on commodity prices, pressure on growth expectations, and concern about future geopolitical order, markets have been somewhat resilient. The S&P 500 index is now trading above the levels at the start of the war.

S&P 500 Index YTD 2022

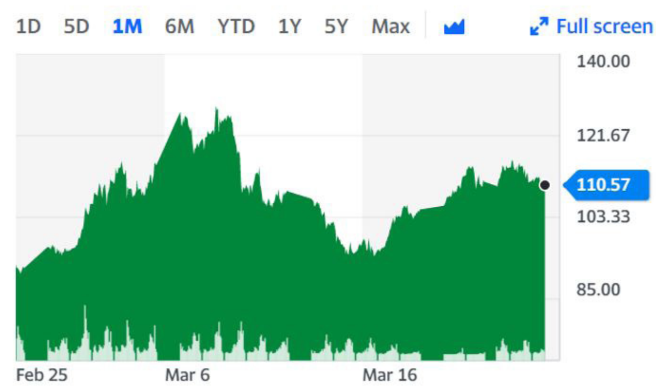
Source: Yahoo Finance

While still down for the year, equity markets have seen the level of fear abate. Illustrative, the CBOE volatility index (VIX) and oil prices have retreated after initially peaking in the week after the commencement of the war.

CBOE Volatility Index (VIX)

Source: Yahoo Finance

Crude Oil Price



Source: Yahoo Finance

In addition to the rise in the equity markets subsequent to the start of the Ukraine War, the 10-year treasury yield has also risen. The key catalyst being the commencement of tightening of monetary policy by the Federal Reserve and a commitment to a more hawkish policy.

10 Year Treasury Yield

Source: Yahoo Finance

This has resulted in the ongoing decline in the overall bond market year-to-date, after a very short period of recovery following the start of the Ukrainian War.

IShares Core U.S. Aggregate Bond Fund ETF (AGG)

Source: Yahoo Finance

Overall, markets have taken the impact of the Ukrainian War in stride. As we enter the last week of the first quarter, incremental news has been limited this week. Absent a major development in the Ukraine War in the near-term, we expect the next catalyst for the markets will be upcoming corporate earnings reports and outlooks starting in mid-April.

2. U.S. Oil & Gas Production Should Grow but Constraints Exist

A major concern catalyzed by the Ukrainian War has been the potential shortage of oil and gas due to sanctions and supply chain disruptions placed on Russian energy exports. Consumers globally are seeing the impact with higher gasoline and energy costs. The desire to mitigate these costs has led to a reevaluation of the economics and ability to increase oil and gas production in the U.S.

From an economic perspective, the shale revolution in the U.S. energy industry of the past 10 years has identified significant resources at declining levels of cost. This resulted in a drop in oil and gas prices over the past decade to a level that were in-line to marginally above the cost of production resulting in a cap on investment. The current pricing based on a recovering economy post the pandemic and compounded by geopolitical concerns has now jumped considerably above the break-even costs of production.

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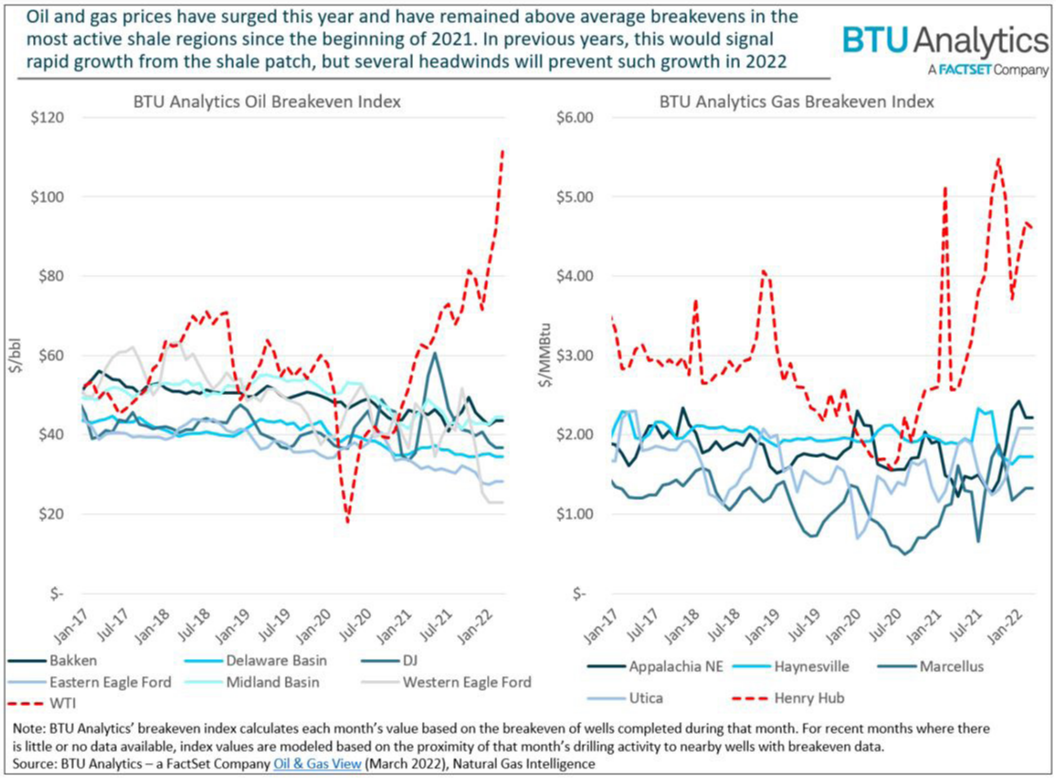


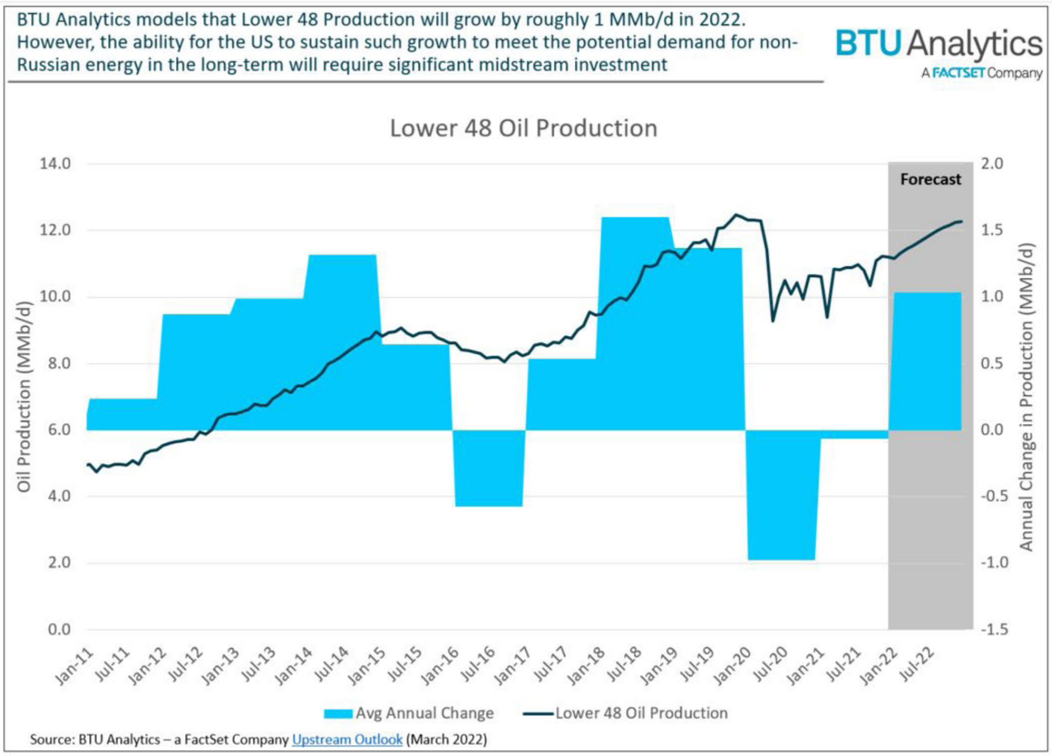
So, on the surface, surging prices have created the economic incentive to increase investment. However, capital priorities by energy companies, public policy, and operating constraints have created a limit to the ability for U.S. producers to respond.

In terms of capital priorities, years of poor returns on capital in the energy space, which was exacerbated by low energy prices during the pandemic on lower demand, has changed the priorities of energy companies. Cash outflows, which traditionally had been directed to growing production, have been redirected to paying down debt, increasing dividends, and buying back stock. While capex can be increased going forward, the ability to restart investment takes time and an expectation that a change in course will not lead back to a period of poor returns.

With high gasoline prices for consumers and geopolitical security concerns, public policy is likely to change at least in the near term. A potential big step was taken this week for U.S. production and infrastructure as discussion proceeded with Europe to replace Russian energy imports with U.S. exports. The primary mode of replacement would be through increased exports of U.S. liquified natural gas (LNG). While signifying a new growth market for the U.S. energy industry, realistically it would require substantial investment in infrastructure including pipelines, compression facilities, terminals, and LNG tankers. This level of infrastructure would take at a minimum several years to put in place.

Shorter term constraints to growing production exist as well. Foremost among these is the limited ability to ramp up activity by labor constraints, material availability, cost inflation, and reinvestment in drilling and fracking equipment. Foremost among these issues near term is labor in the completion of wells. In January, Haliburton, a leading well completions company, noted utilization was above 90% and its business was sold out already for its completion crews. The ability to attract new workers to staff additional completion crews is limited by the low unemployment rate, wariness of potential employees given the hard work and boom-and-bust cycles historically experienced, and need for training. In an unconstrained market, U.S. production response can take roughly six months to materialize but the current environment is likely to see delays.

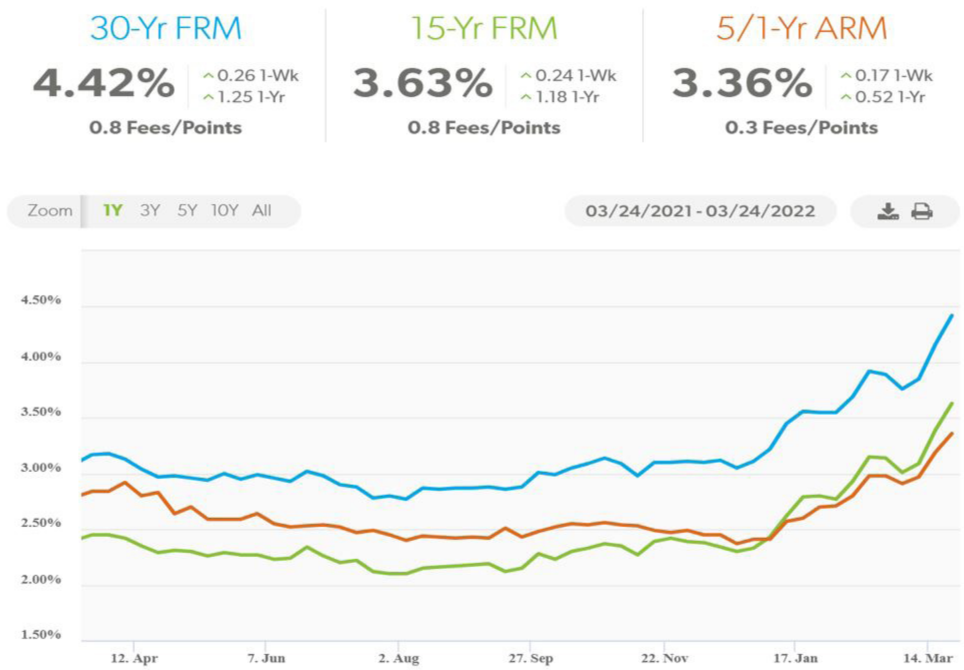
The outlook for incremental U.S. production is positive for 2022. However, it only gets production back to pre-Covid levels. The ability to sustain production and fill the demand for non-Russian energy will require significant investment.



3. Mortgage Rates Increasing

This week, the 30-year fixed-rate mortgage increased by more than a quarter of a percent as mortgage rates across all loan types continued to move up. Rising inflation, escalating geopolitical uncertainty, and the Federal Reserve's actions are driving rates higher and weakening consumers' purchasing power. In short, the rise in mortgage rates, combined with continued house price appreciation, is increasing monthly mortgage payments and could affect homebuyers' ability to keep up with the market.

One-Year Mortgage Rates



Source: FreddieMac

Thinking Ahead

The financial markets this week reflected a period of relative calm as they likely digested events of the past month including the commencement of the Ukrainian War and the start of Federal Reserve rate hikes. Structural hurdles to growth, such as higher energy prices, look likely to persist, although also provide a growth engine for the U.S. energy industry. Homeownership costs also look poised to increase with the upward movement in mortgage rates. Overall, this week was a relatively quiet week for news heading into the last week of the first quarter of a turbulent 2022.

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