PCA Quarterly Commentary

Q1 2022

First Quarter Performance, Outlook for Remainder of Year
Q1 2022

Coming into 2022, financial markets were wrestling with several conflicting issues including a global economy on track to reopen, strong employment, a continuation of COVID difficulties (Omicron), and high inflation. US equity markets were also coming off a strong period of performance supported in part by stimulative monetary and fiscal policy in response to the pandemic. After initially rising, stocks took a dip in January and bond prices slid as inflation readings hit a 40-year high putting pressure on stock valuation multiples and sending bond yields higher.

Markets staged a partial recovery in early February before the threat and eventual invasion of the Ukraine by Russia sent oil and other commodity prices soaring and pushed equity markets into correction territory (falling more than 10% from their recent highs). Bond markets continued to slide on rising interest rates. After bottoming in the first week of March, equity markets staged a strong recovery into the quarter end. Bonds, meanwhile, saw an accelerated sell off as the Federal Reserve commenced a lift off for the Federal Funds rate and took a hawkish stance to combat inflation.

This Pallas Capital Advisors Q1 2022 review will discuss markets, economics, and government actions to judge the implications for equities, bonds, and commodities. We will also discuss some potential market drivers for 2022.

Global Markets Summary

	S&P 500	Russell 2000	MSCI World Ex US	MSCI Emerging Markets	Barclays US Aggregate Bond	Barclays US High Yield VLI Bond
Q1 2022	-4.6%	-7.5%	-4.8%	-7.0%	-5.9%	-4.8%
One Year	15.6%	-5.8%	3.0%	-11.4%	-4.2%	-1.1%

Source: Orion

US equity markets experienced significant volatility in the first quarter of 2022 with the benchmark S&P 500 finishing down -4.6%, after dropping nearly 13% through March 8th from its high for the year on January 3rd. The S&P 500 was a relative outperformer versus the NASDAQ and small cap Russell 2000 which saw returns of -8.9% and -7.5%, respectively. However, with a longer-term viewpoint, the US equity markets have still been strong performers with the S&P 500 up 15.6% over one-year and 22.7% over three years.

First quarter returns diverged materially by sector. Communication service, consumer cyclical, and technology saw the largest pull back, while only energy and utilities were positive.

US Equity Sector Performance

	Performance % Q1 2022	Q4 2021	1Y
Cyclical			
Basic Materials	-1.29	14.35	15.62
Consumer Cyclical	-10.66	9.29	4.95
Financial Services	-3.01	1.25	9.38
Real Estate	-6.22	13.11	20.62
Sensitive			
Communication Services	-12.20	-2.20	-5.01
Energy	38.47	5.74	64.37
Industrials	-3.82	7.05	5.23
Technology	-9.66	15.64	19.12
Defensive			
Consumer Defensive	-1.31	9.52	13.44
Healthcare	-4.03	7.40	13.33
Utilities	4.48	12.29	19.19

Source: Morningstar Direct, Morningstar U.S. Sector Indexes. Data as of March 31, 2022.
Performance shown in Total Return USD.

International equity markets underperformed the US equity markets with emerging markets lagging developed markets both year-to-date and over the past year. Overall, geopolitical instability and greater exposure to commodity (energy and food) inflation have driven greater near-term concerns about growth globally. Roughly one-third of Western Europe's natural gas comes from Russia. Some global regions have benefited, such as Canada and Brazil, as they are seen as beneficiaries of higher commodity prices.

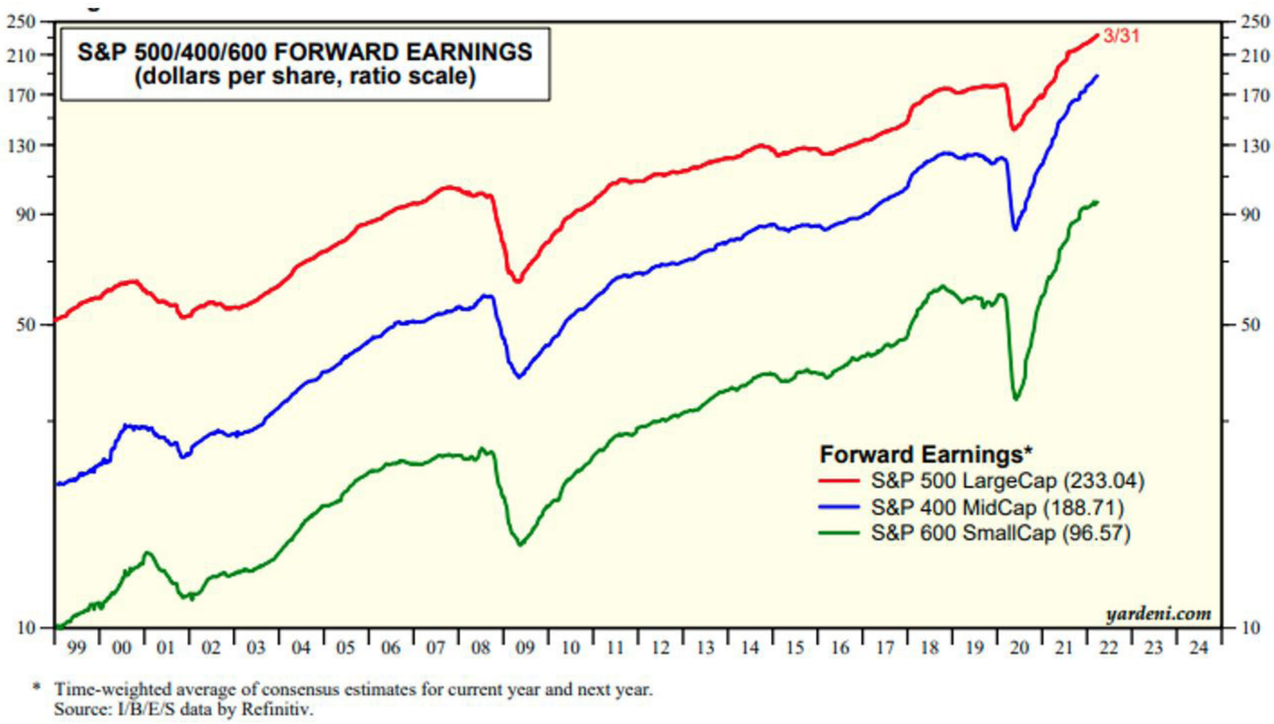
While the performance of equity markets was disappointing in the first quarter, the negative performance of the US aggregate bond index (-5.9%) was perhaps more notable as it saw its worst quarterly performance in over 20 years. Longer-term bonds, which have the greatest sensitivity to interest rate changes, were hit the hardest, but even shorter-term bonds have declined given the rapidity in the rise of shorter-term notes such as the two-year treasury which has seen its yield rise to 2.3% from 0.8% at the start of the year. Government securities have outperformed their corporate counterparts of similar duration, likely reflecting a defensive posture. However, on the corporate side, credit metrics remain strong, although the flattening of the yield curve has elevated concerns about future economic growth or even recession.

A relative area of strength for fixed income year to date has been the private credit markets whose primary product is direct lending to small companies. With the continuing strength in credit metrics, private credit markets, which focus on floating-rate debt, are positioned to increase their interest rates on their loans as market rates rise. Private real estate has also been an area of relative stability for income-oriented portfolios as future yields are expected to offset inflation with leverage created by rent increases.

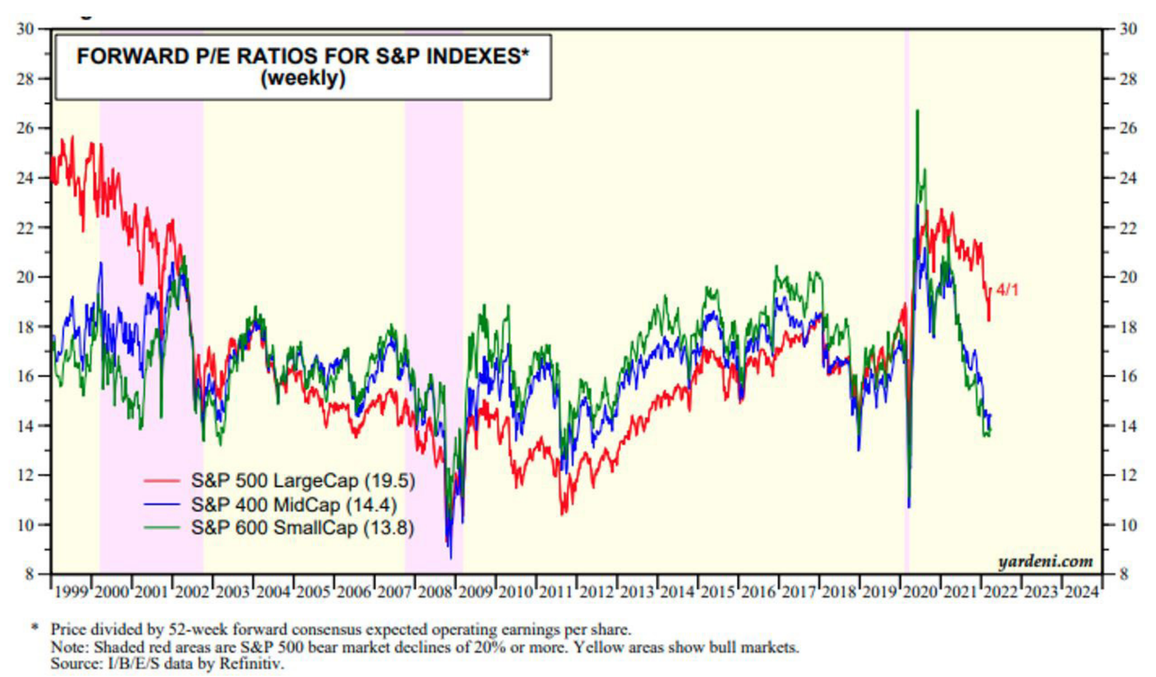
Commodities were the big gainer for the quarter. Prices were already on the rise as demand from the global recovery from the pandemic had been pressuring supplies. Oil prices that started the year at about $75 per barrel spiked to a 14 year high of $125 after Russia attacked Ukraine. Oil prices retreated to closer to $100 barrel by the end of the quarter as sanctions and disruptions became better understood, and the US announced the release of oil reserves. However, this still represented an increase of 33% for the year-to-date and 70% for one year. Wheat and metals prices also jumped during the quarter after Russia invaded Ukraine. Both countries are top exporters of agricultural products and metals. Gold rose from approximately $1800 an ounce to $1949, or 8.2%. The price reached a peak in the first week of March following the invasion and has pulled back steadily since.

Market Outlook - Q2 2022

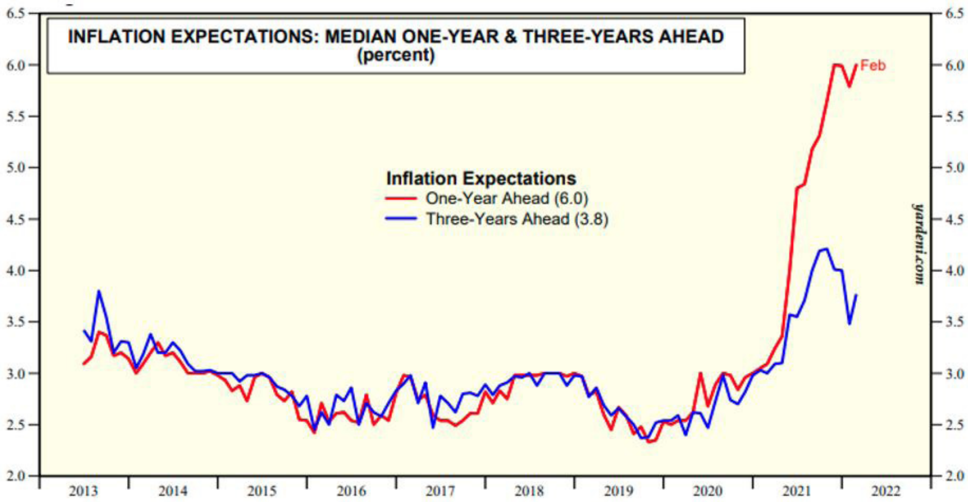
While the markets have been on a wild ride in 2022, the overall earnings expectation for large, mid and small-cap companies for 2022 have continued to show recovery from the pandemic and following the latest round of earnings reports (Q4 2021) have in aggregate been upwardly revised.



While earnings estimates have been stable and continue to be revised upward, albeit not near the pace of revisions in 2021, forward price to earnings ratios (P/E ratios) have been declining. The forward P/E decline has been particularly pronounced for mid and small-cap stocks. Conversely, the higher multiples of mega-cap stocks (companies with a market capitalization of over $200 billion) have a greater impact on the overall multiple of the S&P 500.



The decline in multiples is being driven by expectations for slower growth ahead and higher interest rates. Both drivers are seen as offshoots of higher inflation, which in turn is driving a more hawkish Federal Reserve policy. Expectations for inflation have risen and been exacerbated by the war's impact on energy prices and food prices.

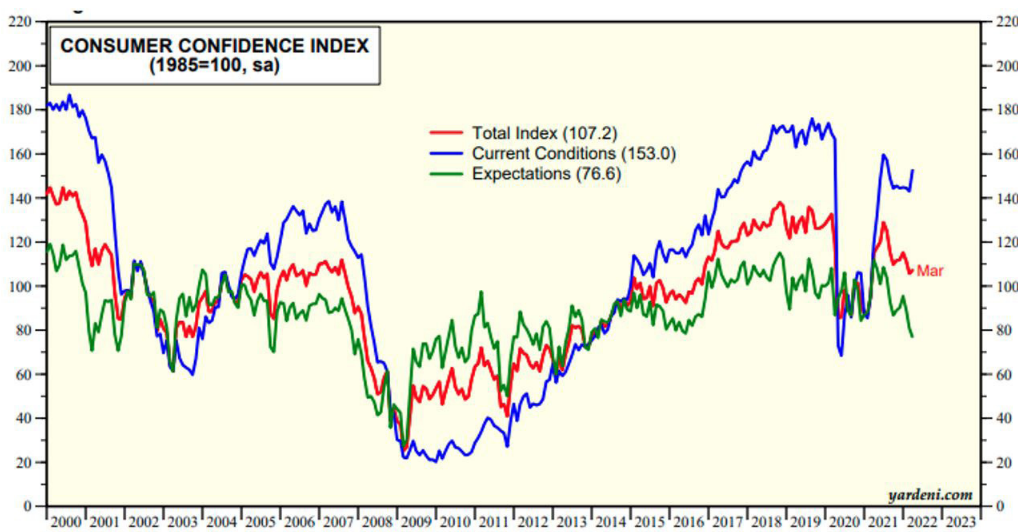


Source: Federal Reserve Bank of New York.

The impact of higher prices on such staples is expected to eventually have a negative impact on consumer spending for other goods and services, slowing growth more broadly. For the time being, economic momentum from the ongoing reopening from the pandemic, a strong labor market, and a higher level of savings built up during the past two years are likely smoothing consumption near term.

The Federal Reserve is taking advantage of the current period of economic momentum to adopt a more aggressive posture on monetary policy. The Fed started tightening in March and is now expected to raise rates at each policy meeting for the next several months and start reducing (selling debt securities) their balance sheet. The impact is raising interest rates which have a near-term negative impact on the value of long duration assets such as equities (particularly growth equities that are more sensitive to future cash flows) and bonds with longer maturities. The Fed's policy is also consistent with putting the brakes on the economy leading to slower growth.

An expectation for slower growth and higher interest rates in the near to medium term is likely well-telegraphed in the financial markets and present in the current valuation levels. As long as tensions in Ukraine resolve in the coming months and COVID-19 infection rates don't flare up again, the disruption to the economy in the coming months is likely to be mitigated and, currently, the probability of an economic recession in the US appears low for the next year. However, uncertainty remains high and will likely weigh on market sentiment. This is particularly illustrated in consumer sentiment expectations, which have fallen to below levels seen at the time of the pandemic despite current conditions remaining favorable from a historical perspective.



Source: The Conference Board.

BRAINTREE, MA
45 Braintree Hill Office Park, Ste. 201
Braintree, MA 02184
781.971.5052

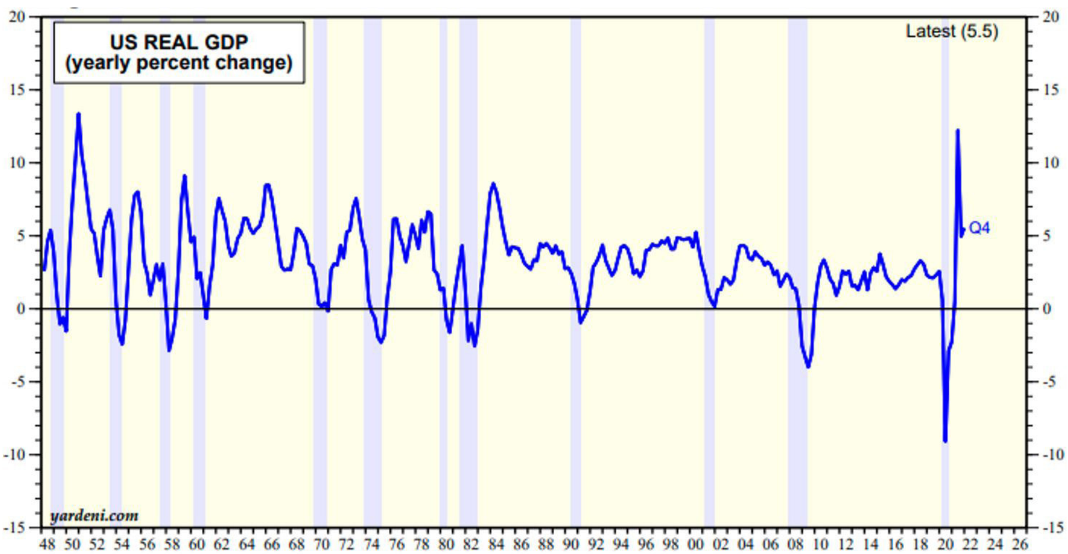
PORTSMOUTH, NH
36 Maplewood Ave
Portsmouth, NH 03801
603.292.3699

PARK RIDGE, NJ
1 Maynard Drive, Ste 2101
Park Ridge, NJ 07656
551.277.2686

WAKEFIELD, MA
701 Edgewater Drive, Ste. 140
Wakefield, MA 01880
781.971.5040

We expect that consumer spending, which comprises 70% of US GDP, could be negatively impacted relative to expectations coming into the year. This again has likely been incorporated by the financial markets as forecasts for GDP growth in 2022 have already been reduced, particularly for the first half of the year. The size of the revisions has been more material in international markets, namely continental Europe, impacting international markets to a greater extent. The expected slowdown in growth may well materialize in the coming months with greater caution in corporate earnings outlooks.

Ultimately, we expect that geopolitical tensions and inflation will subside, although will likely remain above the Fed's long-term target of 2% for some time. The economic environment at that time will likely reflect a post-pandemic recovery, improved supply chains, and lower energy costs resulting in a return to a long-term trend line for US economic real growth (adjusted for inflation) of 2-3% or 4-5% in nominal terms.



Note: Shaded areas are recessions according to the National Bureau of Economic Research. Dotted line is 2% "stall speed."
Source: Bureau of Economic Analysis.

The longer-term view suggests that markets are likely to eventually return to a period akin to the past 30 years. In this environment, businesses with the ability to put up consistent, attractive earnings growth are likely to see their stocks appreciate over time. Fixed income should also see greater stability and historical patterns of return as inflation and the Fed's response to counter it is mitigated.

Conclusion

2022 is off to a volatile start with financial markets selling off in a historic fashion with both equity and bond markets in the red. The overriding driver of the volatility has been historically high inflation exacerbated by the war in Ukraine. Corporate earnings have yet to be revised lower, but prospects for growth are likely to be under pressure. A combination of lower expected growth prospects and higher interest rates may continue to put pressure on valuation metrics for both equities and fixed income. In the near term, uncertainties are elevated but longer-term, putting a break on inflation and an eventual resolution to the Ukrainian war should be a positive for the markets. Pallas Capital will continue to focus on quality, long-term investments, including private markets, to help clients achieve their goals.

Sincerely,

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

Stephen Kylander
Senior Portfolio Manager
Pallas Capital Advisors

The information contained herein is for informational purposes only, is not personalized investment advice and should not be construed as a recommendation to purchase or sell any particular security, sector or strategy to any individual person or entity. The decision to review or consider the purchase or sale of any security, sector or strategy mentioned should not be undertaken without consideration of your personal financial information, investment objectives and risk tolerance with your financial professional. Past performance should not be considered as an indicator of future results.

Investment Advice offered through Pallas Capital Advisors LLC, a registered investment advisor.