PALLAS
CAPITAL ADVISORS

Week in Review

Friday, April 15th, 2022

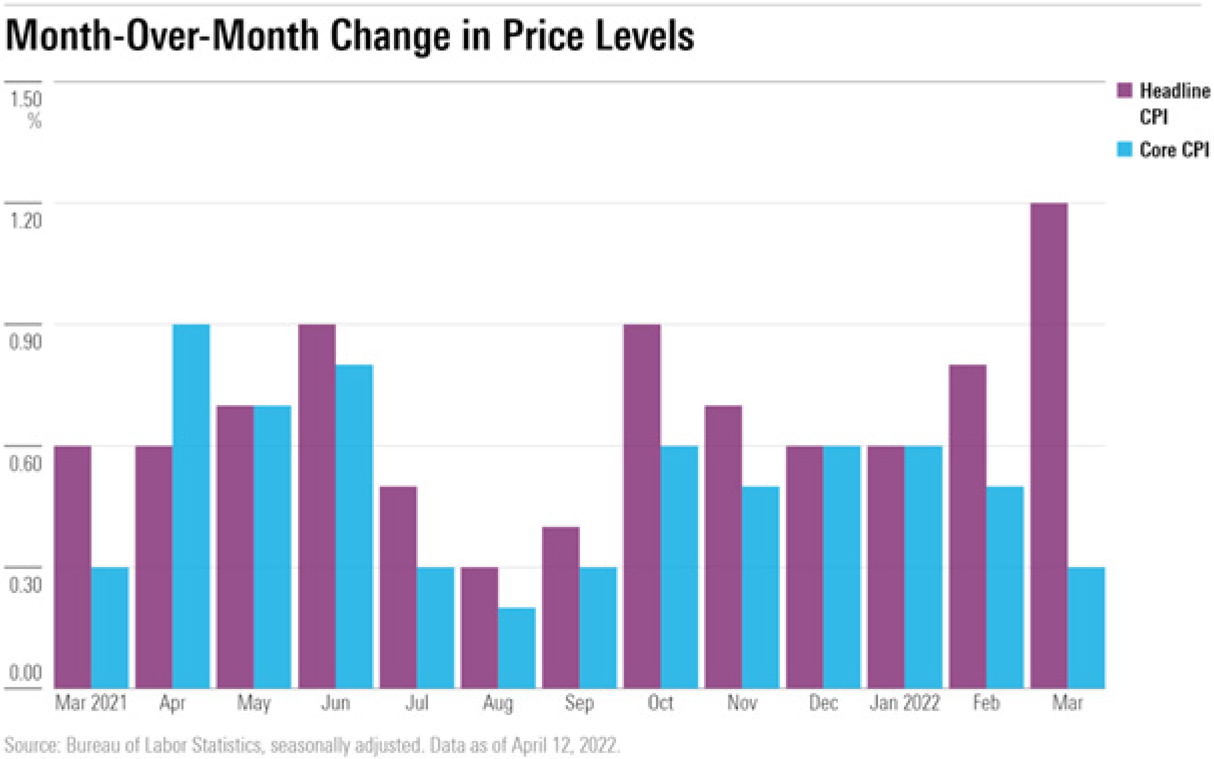
1. March Inflation Hits a 40-year High – Peak?

The March reading for the Consumer Price Index (CPI) was released this week and showed headline inflation rising to 8.5%, the highest level since December 1981. The March reading followed a 7.9% rise in consumer inflation in February. The CPI is a measure that examines the average prices of a basket of consumer goods and services.

More than half the overall 1.2% rise in the CPI from March was due to an 18.3% jump in gasoline prices. Food costs rose 1% in March, with all six major grocery store food group indexes posting increases. Excluding food and energy costs, CPI rose 6.5% in March from a year earlier, the largest 12-month change since August 1982.

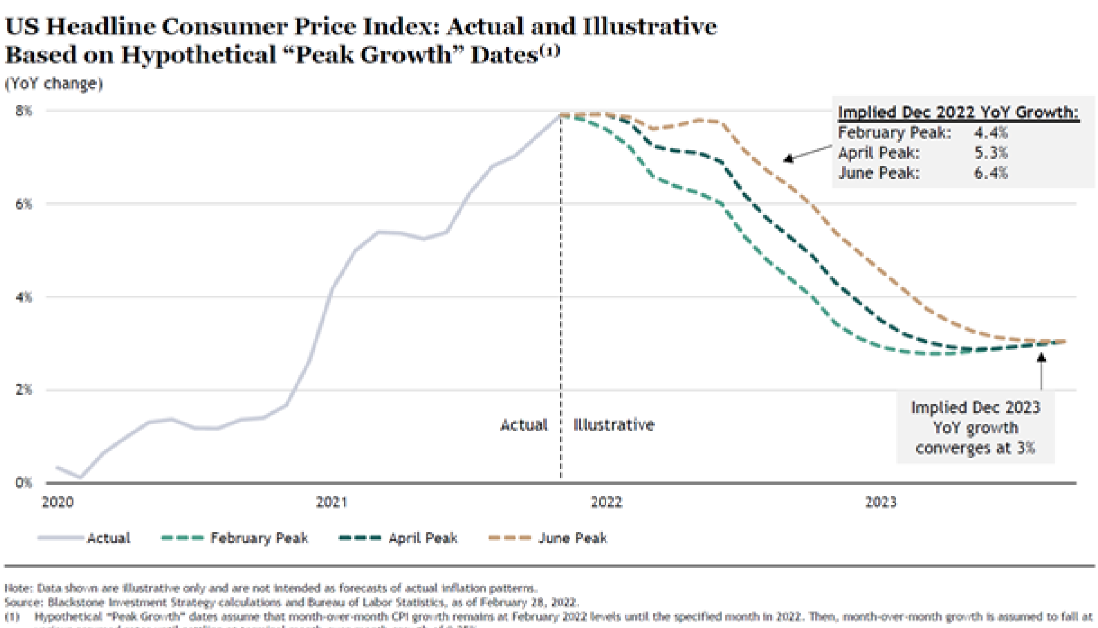
The CPI index readings are closely watched by the financial community in terms of their influence on interest rate policy by the Federal Reserve. Over the past several months, the Federal Reserve has become increasingly hawkish indicating that they expect to aggressively raise interest rates to head off inflation. This has pressured financial asset valuations impacting both the bond and equity markets.

On the surface, the CPI data would seem to add fuel to a stepped-up fight against inflation, but the month-to-month deceleration in the growth of core CPI was taken as an indication that inflation may have peaked, particularly given the recent pullback in energy prices from the peak prices in March.



Source: Morningstar

The argument for peak inflation having been realized is that calendar year comparisons will be easier, certain goods such as used cars and lumber have already seen price declines, and supply broadly is catching up to demand. The following chart illustrates implied decline curves for inflation based on varying month-to-month peak growth rates with all curves converging at 3% by late 2023.



Source: Blackstone

The potential that peak inflation may have or will soon be realized has short-term sentiment improving for financial assets. Both bond markets and equity markets saw appreciation following the CPI release which could signify a notable change in market sentiment.

While the markets have gotten through the latest CPI reading and are less fearful of valuation metrics, attention will now turn to fundamentals as companies release their first-quarter results and outlooks for the rest of the year.

2. Quality Equities on Sale in 2022

Factors have been a popular mode of evaluating stock and portfolios and their correlation with returns in varying markets. MSCI provides analysis of different factors and has tracked their performance over time. The following chart describes the eight categories that MSCI follows.

Factor groups	What it is
Value Relatively inexpensive stocks	Captures excess returns to stocks that have low prices relative to their fundamental value
Low size (small cap) smaller companies	Captures excess returns of smaller firms (by market capitalization) relative to their larger counterparts
Momentum rising stocks	Reflects excess returns to stocks with stronger past performance
Low volatility lower risk stocks	Captures excess returns to stocks with lower than average volatility, beta, and/or idiosyncratic risk
Dividend yield cash flow paid out	Captures excess returns to stocks that have higher-than-average dividend yields
Quality sound balance sheet stocks	Captures excess returns to stocks that are characterized by low debt, stable earnings growth, and other "quality" metrics
Growth Measure of change in sales and earnings	Measures company growth prospects using historical earnings, sales and predicted earnings
Liquidity Size-adjusted trading volume	Captures common variations in stock trading volumes relative to available shares trading

Source: MSCI

Based on performance as of the latest quarter, the top-performing factor on a 3-year, 5-year, and 10-year basis has been quality. While performance was strong through year-end 2021, performance for the quality factor in the first quarter of 2022 fell to the bottom of the group.

ELEMENTS OF PERFORMANCE Factors by MSCI	MSCI Factor Performance Heat Map - USA

Gross Performance as of 03/31/2022 in USD

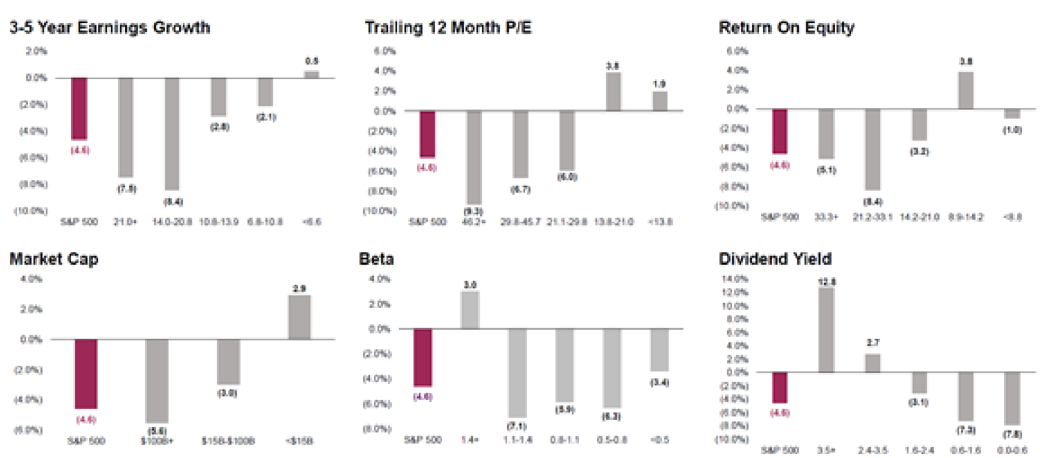
Index Name	1D	1W	1M	3M	YTD	1Y	3Y	5Y	10Y
MSCI USA Index	**-1.6%**	**0.2%**	**3.5%**	**-5.2%**	**-5.2%**	**14.1%**	**19.1%**	**16.1%**	**14.6%**
MSCI USA Minimum Volatility Index	-0.9%	1.6%	5.5%	-3.8%	-3.8%	13.8%	11.8%	12.5%	13.0%
MSCI USA High Dividend Yield Index	-1.3%	0.1%	2.6%	-1.5%	-1.5%	11.4%	10.6%	10.6%	12.2%
MSCI USA Quality Index	-1.5%	0.5%	3.8%	-8.8%	-8.8%	12.0%	19.4%	17.8%	15.5%
MSCI USA Momentum Index	-1.6%	-0.1%	4.7%	-7.3%	-7.3%	4.8%	15.4%	16.6%	15.7%
MSCI USA Enhanced Value Index	-1.9%	-1.0%	0.3%	-3.8%	-3.8%	4.9%	12.6%	10.4%	12.5%
MSCI USA Equal Weighted Index	-1.4%	0.2%	2.2%	-4.9%	-4.9%	9.9%	15.9%	13.2%	13.3%
MSCI USA Growth Target Index	-1.6%	0.5%	2.9%	-6.3%	-6.3%	6.0%	14.3%	14.1%	15.3%

Source: MSCI

The long-term results are consistent with the positive attributes of businesses that are considered to be of high-quality including consistency of earnings and growth, high returns on equity, and larger market cap. These attributes tend to exist in market leaders with long-term competitive advantages, operating in attractive markets.

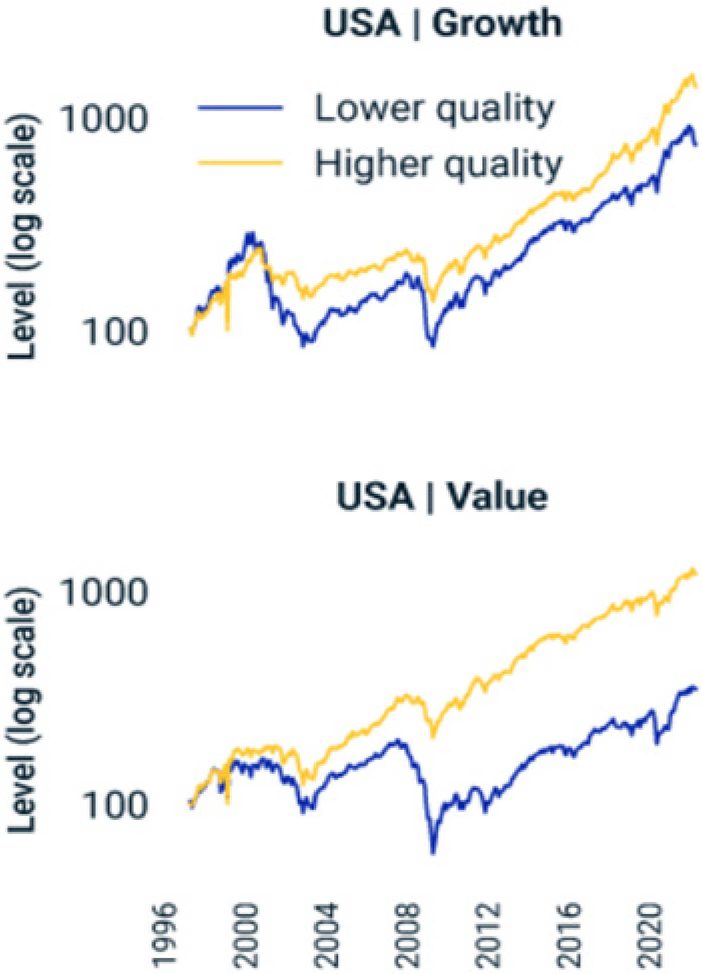
Interestingly, a number of these financial attributes were not rewarded in the first quarter, and in many cases the converse outperformed. For example, low ROEs outperformed high ROEs, low growth outperformed higher growth, the highest beta outperformed lower beta, and mega caps underperformed their smaller counterparts.

S&P 500 Index: YTD Analysis



Source: Eaton Vance

Since the financial attributes of the quality companies did not materially change in the first quarter, what did likely work against the quality factor is relative valuation metrics as lower price to earnings and high dividend yield were positive factors for the quarter. That being said, quality should not be mistaken for speculative growth and in fact, is comprised of both growth and value equities and thus falls within the blend style group as defined by Morningstar. Within value and growth style groups, higher quality metrics have outperformed lower quality metrics historically.



Source: FactSet

It is likely that quality factor businesses were a beneficiary of the high level of liquidity in the markets driven by easy monetary policy and stimulus as a response to Covid-19. The rapid change in policy by the Federal Reserve likely has been a near-term headwind.

Longer-term, favorable business attributes should reassert their influence in terms of superior earnings growth and financial returns. The silver lining for the recent relative underperformance of quality is that valuation should be less of a short-term concern and little relevance with a longer-term horizon.

3. It's Tax Season – Capital Gains

Articles in the financial press have commented about significant capital gains being paid out by mutual fund companies in 2021. Some factors driving this include the S&P500 doubling in value in the three years ending December 2021, and the funds having higher portfolio turnover due to the pandemic trading. Generally, portfolios got defensive in early 2020, then offensive in early 2021.

Pallas Capital portfolios have been more tax-efficient than many mutual funds, but they have been subject to the same trends. Many Covid beneficiary stocks ran ahead of their price targets and needed to be sold to fund positions in cyclical companies as vaccines were rolled out and a new administration in Washington increased fiscal spending. These inflection points are not common, but we must react when they do. Many of the positions we sold due to exceeding our price targets are now lower in price. PCA is very mindful of after-tax returns and typically targets capital gains below 3-4% of a portfolio.

Thinking Ahead

The big macro news this week was the release of the most recent data points on inflation, which is being watched closely for its influence on Federal Reserve policy and in turn has an impact on equity and bond valuations. While data showed inflation at very elevated levels, some of the data also suggested a potential peak level is being put in place. As short-term fear abates about inflation, attention is likely to return to long-term business fundamentals. Businesses demonstrating "quality" characteristics will likely benefit from such a change in focus. Finally, it's mid-April, meaning tax season and the time to account for taxable activity in the past year.

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