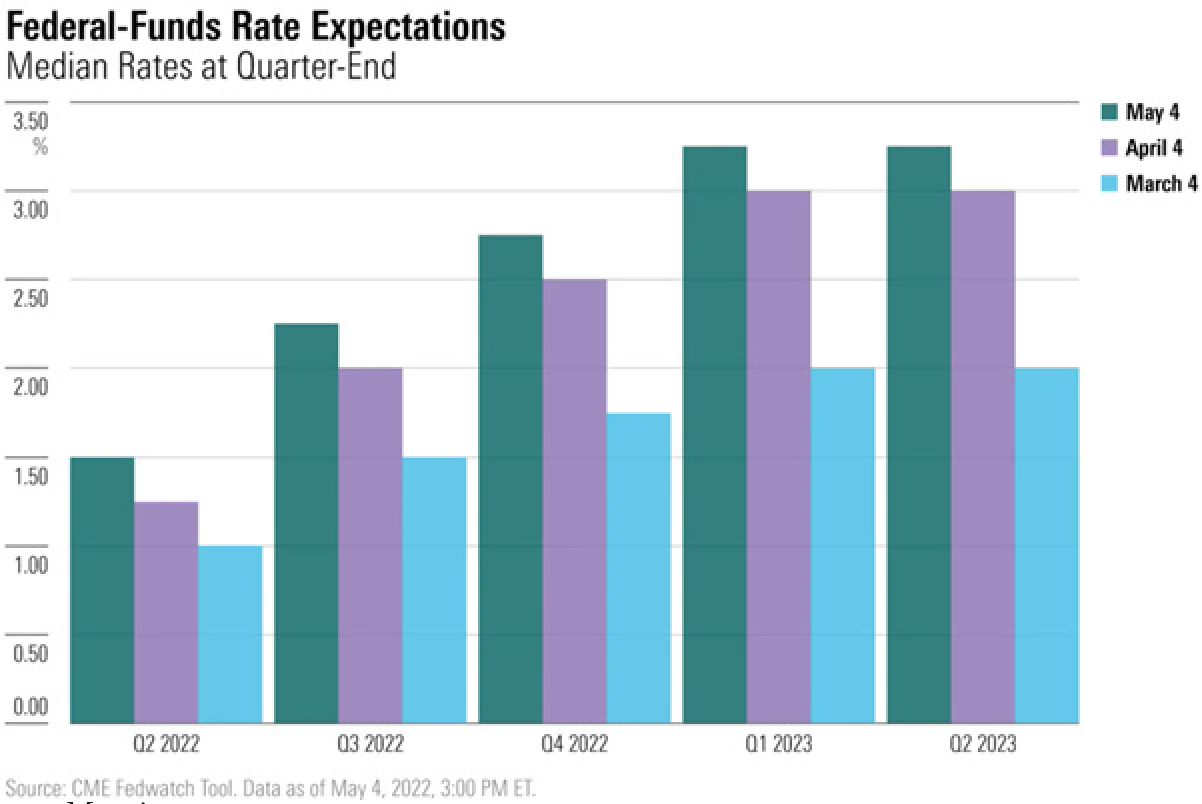
PALLAS CAPITAL ADVISORS

Week in Review

Friday, May 6th, 2022

1. The Federal Reserve Rate Increases; All Eyes on Inflation

As anticipated, the Fed announced a 0.5% increase to the Federal Funds rate this past week. Of perhaps greater interest, however, were the comments made at the press conference following the release. In the press conference, Federal Reserve Chairman Powell iterated an expectation that the next two meetings would likely also see 0.5% rate increases putting the end of the year target at around 3%. This would be the highest level for the Federal Funds rate since before the financial crisis in 2008.

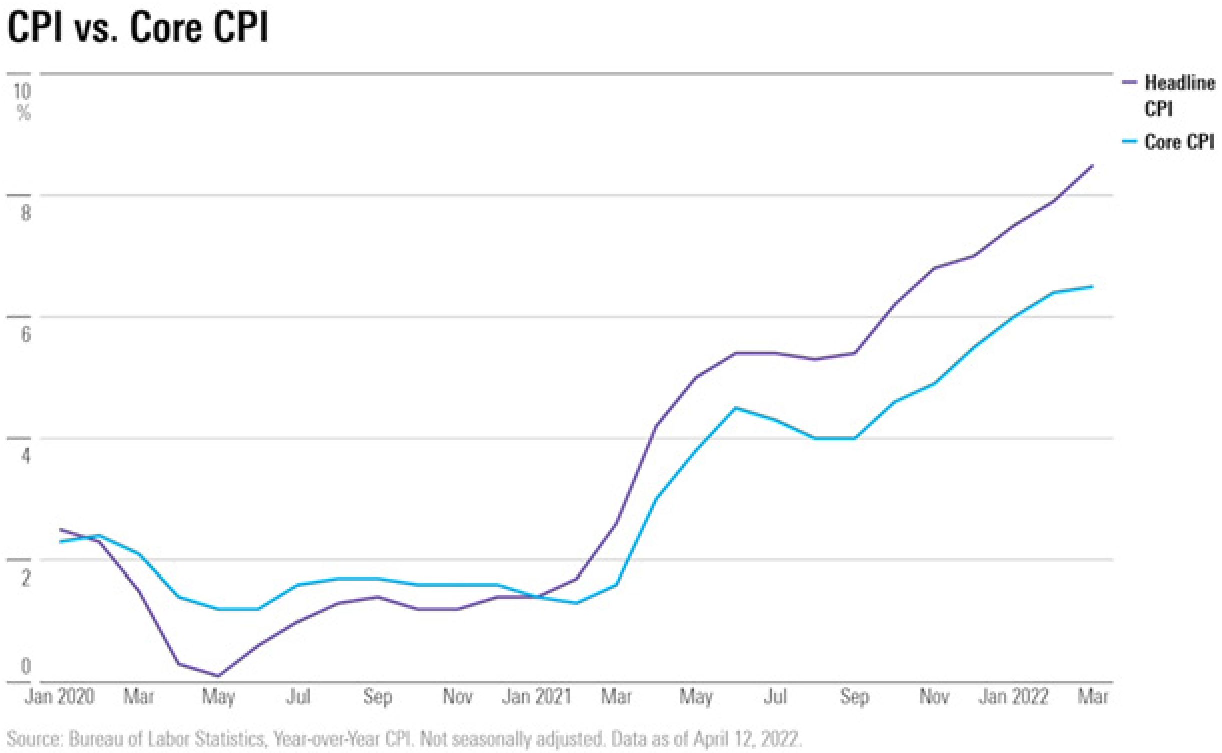


Source: Morningstar

While the pace of increases discussed by Chairman Powell has recently been anticipated, it is very notable that the level is around a full 1% greater than median expectations just 2 months ago. Chairman Powell also announced that the Federal Reserve would commence selling treasuries and mortgage-backed securities on June 1st. The increase in rate expectations and balance sheet deleveraging has been the key driver behind the decline in financial assets including bonds and equities.

There is currently a large amount of debate as to whether the pace of rate increases will be sufficient to cool the economy and achieve the Fed's stated goal of price stability by reigning in inflation. While the Fed can influence demand, it has little control over the supply side of the equation for inflation which is being pressured by ongoing supply chain constraints, China Covid shutdowns, and the war in Ukraine. Concerns are present that the Fed will need to be even more aggressive to curb demand which elevates the risk of triggering a recession.

The key metric the Fed will be watching going forward will be inflation with the common measurement being Core CPI. Core CPI is an aggregate measurement of a typical basket of goods paid by consumers, excluding food and energy (included in overall CPI).



Source: Morningstar

There is an expectation that Core CPI may be at or near the peak. However, Core CPI will likely remain elevated for a prolonged period above the Fed's target of 2%. The bond market has likely priced in a medium-term level of near 3% based on the current yield for two-year Treasuries yielding near that level and in line with the expectation for the Federal Funds rate. If confidence can grow that a 3% level of medium-term inflation is reasonable, pressure will likely stabilize in terms of asset valuations. The hope is that lower inflation can be achieved by the Fed without causing a recession and driving down earnings and credit, the other components of financial asset valuation.

2. Morningstar Equity Market Valuation Moves to Undervalued

At the start of the year, Morningstar saw equity markets as slightly overvalued and saw four factors that could impact further growth. The four factors were:

- Declining economic growth
- Federal Reserve tightening monetary policy
- Rising Interest rates
- Inflation

All of these factors have come to pass in 2022 with the greatest negative factor being rising inflation which has more than offset continued growth in corporate earnings, albeit lower than the pandemic recovery driven 2021, relative to expectations at the beginning of the year.

The broad market sell-off driven for the most part by declining valuation multiples has now reversed Morningstar's assessment of market prices versus fair valuation. Based on a broad composite of stocks followed by Morningstar's equity research team, Morningstar believes that the U.S. equity market is now trading at a 12% discount to fair value, relative to fair to slight premium at the beginning of the year.

U.S. Equity Market Price/Fair Value Based on Morningstar's Equity Coverage

	All Coverage	Value	Core	Growth
All	0.88	0.89	0.95	0.83
Large	0.88	0.90	0.96	0.83
Mid	0.89	0.89	0.93	0.85
Small	0.79	0.75	0.84	0.80

Source: Morningstar

Of note in Morningstar's analysis is that market price to fair value can be found across style and market cap sizes. While Morningstar sees discounts across style and market size metrics, their analysis does find pockets of stocks they deem priced at premiums to their fair values. Morningstar deems that as markets have sold off, investors have fled to defensive sectors. Based on their analysis of sectors, consumer defense (staples) is the most overvalued sector under their coverage trading at a 10% premium based on their methodology.

While the determination of fair value is not an exact science, Morningstar's broad coverage and consistent methodology provide at least a guidepost that the current correction has removed perceived valuation excess coming into the year.

Thinking Ahead

Another week has brought extreme volatility as well as incremental data points from frenetically watched Federal Reserve policy. The path to higher interest rates is pacing as recently expected but the rapid rise in expectations that has taken place year to date has had a meaningful impact on the valuation of bonds and equities. While market drivers, notably inflation and economic growth, are still unknown, the uncertainty has reset financial asset valuations to a more attractive level than entering the year.

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