PALLAS
CAPITAL ADVISORS

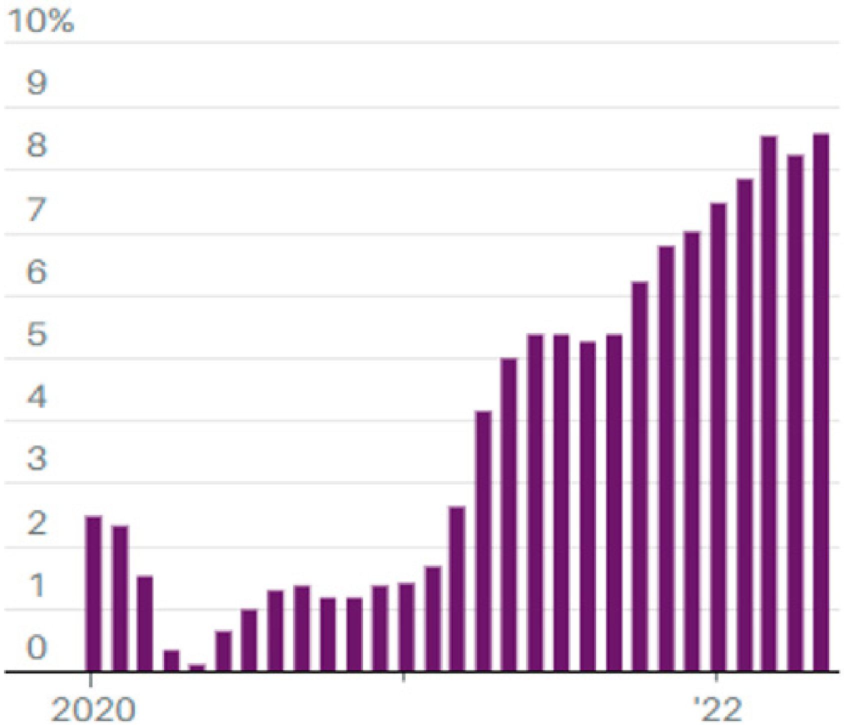
Week in Review

Friday, June 10th, 2022

1. Consumer Price Index for May Shows No Respite from Inflation

Consumer prices increased 1% in May on a month over month basis compared to a 0.3% increase in April, and on an annualized basis rose 8.6% versus 8.3% in April, reaching a new cycle high previously set in March. May's annual increase represents the largest annual increase since December 1981. The resurgence in inflation counters the hope for peak inflation and will intensify pressure on the Federal Reserve to continue its aggressive campaign to tighten monetary policy.

CPI Year-Over-Year Change



Source: Labor Department

Core CPI, which excludes the volatile energy and food segments, rose 0.6% in May, the same pace as in April. Economists had expected core inflation to slow to a 0.5% increase in May, versus a 0.5% in April. On an annualized basis core inflation rose 6% over the prior year in May, more than the 5.9% that was expected.

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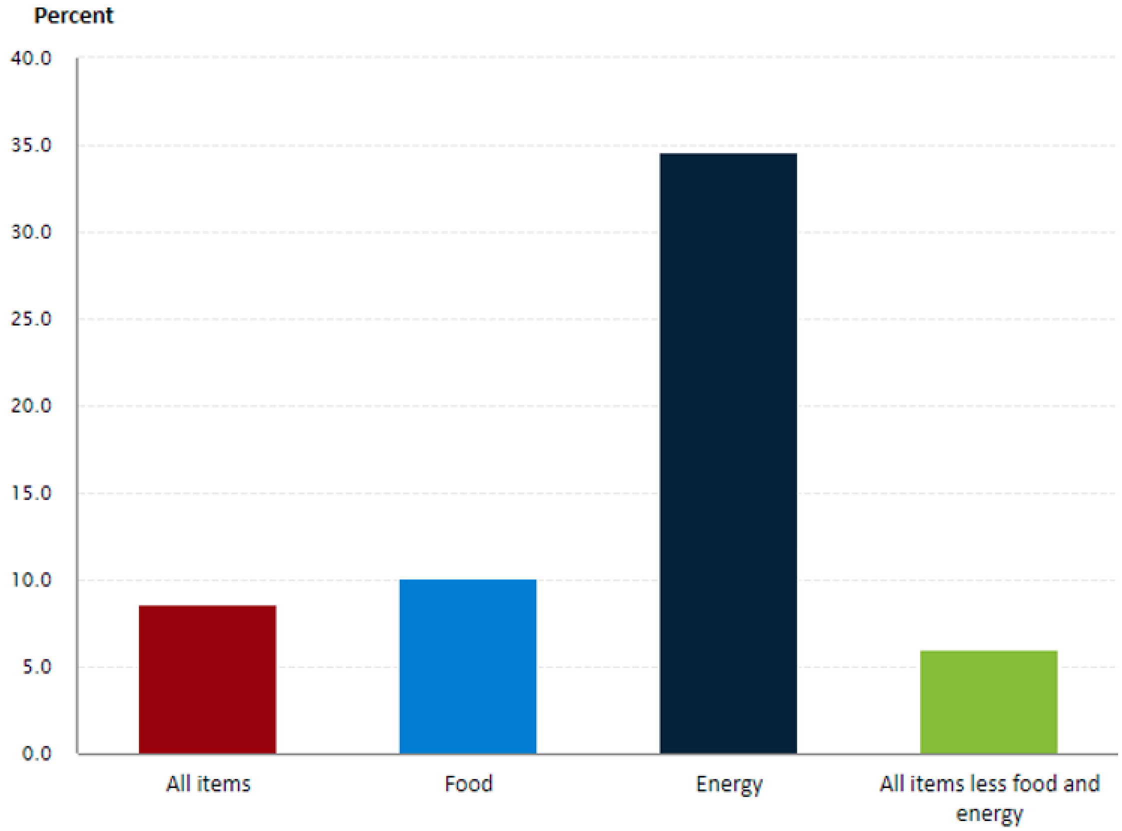
Year-Over-Year Change in Major CPI Categories



Source: U.S. Bureau of Labor Statistics.

The biggest contributors to the latest jump in inflation were shelter, gasoline, and food according to the BLS. The energy index rose 3.9% month-on-month in May, with the gasoline index rising 4.1%. Compared to the prior year, energy prices in May were up 34.6%, the most since September 2005. Meanwhile, the food index rose 1.2% from April to May and 10.1% over the prior year, the largest jump since March 1981. The cost of shelter rose 0.6% in May when compared to the prior month, the largest jump since March 2004. Owners' equivalent rent, a component of the shelter index, rose 0.6% in May, the most since August 1990.

The implications for sharp increases in May will be a strain on consumers as they must keep paying higher prices. The Federal Reserve will likely continue to raise interest rates to try to slow the economy and tame inflation, but it will take time. For financial markets, the implications will likely be lower valuation multiples to take into consideration the higher interest rates, slower expected growth, and concern about recession.

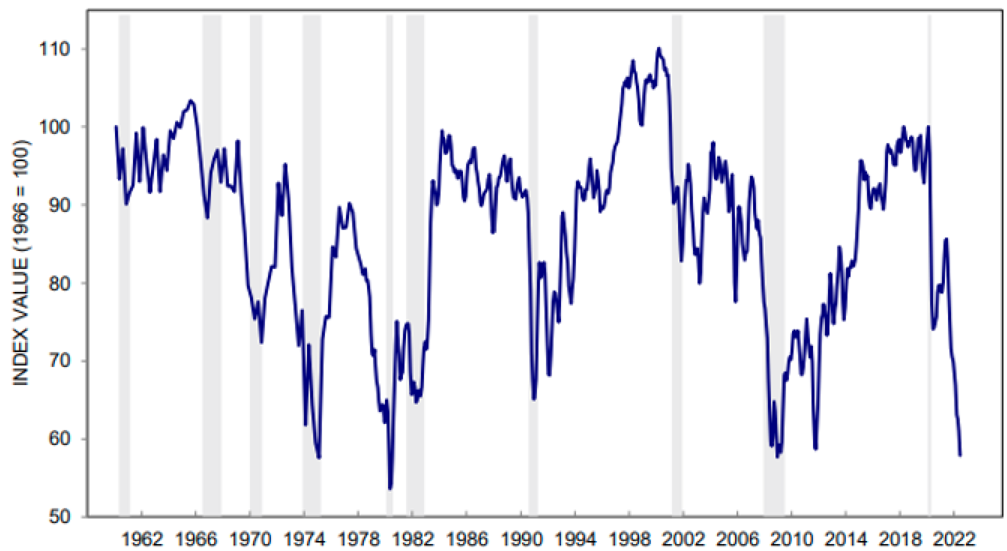
2. University of Michigan Consumer Confidence Index Continues to Decline

The University of Michigan's Consumer Sentiment Index slumped to 50.2 in the preliminary June survey, marking among the lowest level recorded by the survey. The decline has been rapid as the index declined by 14% on a month over month basis, continuing a downward trend over the last year and plumbing near its lowest recorded value, comparable to the trough reached in the middle of the 1980 recession.

The Index of Consumer Sentiment

	Jun 2022	May 2022	Jun 2021	M-M Change	Y-Y Change
Index of Consumer Sentiment	**50.2**	58.4	85.5	-14.0%	-41.3%
Current Economic Conditions	**55.4**	63.3	88.6	-12.5%	-37.5%
Index of Consumer Expectations	**46.8**	55.2	83.5	-15.2%	-44.0%

THE INDEX OF CONSUMER SENTIMENT

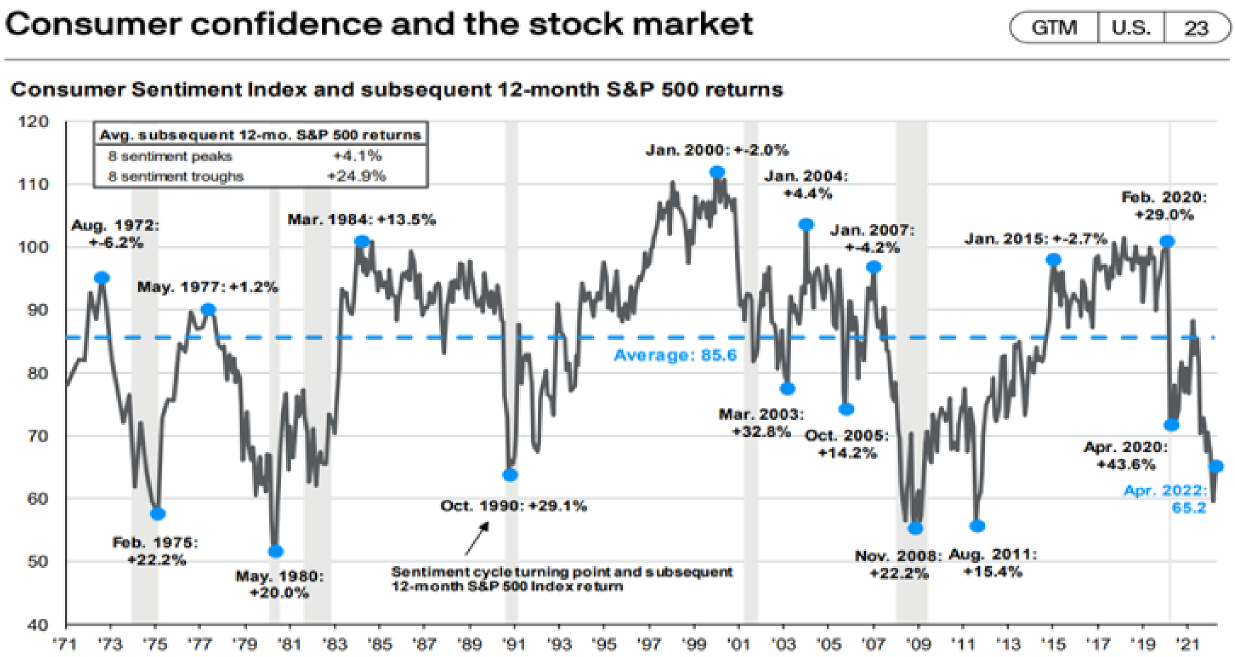


Source: University of Michigan

All components of the sentiment index fell this month, with the steepest decline in the year-ahead outlook in business conditions, down 24% from May. Consumers' assessments of their personal financial situation worsened about 20%. Forty-six percent of consumers attributed their negative views to inflation, up from 38% in May; this share has only been exceeded once since 1981, during the Great Recession. Overall, gas prices weighed heavily on consumers, which was no surprise given the 65 cent increase in national gas prices from last month according to AAA.

Half of all consumers spontaneously mentioned gas during their interviews, compared with 30% in May and only 13% a year ago. Consumers expect gas prices to continue to rise a median of 25 cents over the next year, more than double the May reading and the second highest since 2015. In addition, a majority of consumers spontaneously mentioned supply shortages for the ninth consecutive month.

Looking for a silver lining, consumer confidence and trailing stock market returns have historically been inversely correlated.



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According to the data compiled by J.P. Morgan, 12-month market returns after the last 8 sentiment troughs at +24.9% have far outpaced the returns following consumer sentiment peaks at +4.1%. While past performance is not necessarily indicative of future performance, it is probably fair to surmise that markets are pricing in negative consumer sentiment as well as other concerns such as Federal Reserve tightening policy, the Ukraine War, higher energy prices and inflation, supply chain constraints, and risk of recession. It is likely that the deluge of concerns should subside with time.

Thinking Ahead

This past week saw the continued erosion in financial market valuations on the back of negative data points for the current economic back drop, notably the much-anticipated Consumer Price Index data for May. The higher-than-expected inflation data will defer the anticipated peak inflation story line which continues to be a major depressant of consumer sentiment. We expect that the Federal Reserve will need to act with resolve to address inflation, slowing growth, but remain confident that inflation can ultimately be curbed without incurring a deep recession and triggering credit and liquidity risk.

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