PALLAS CAPITAL ADVISORS

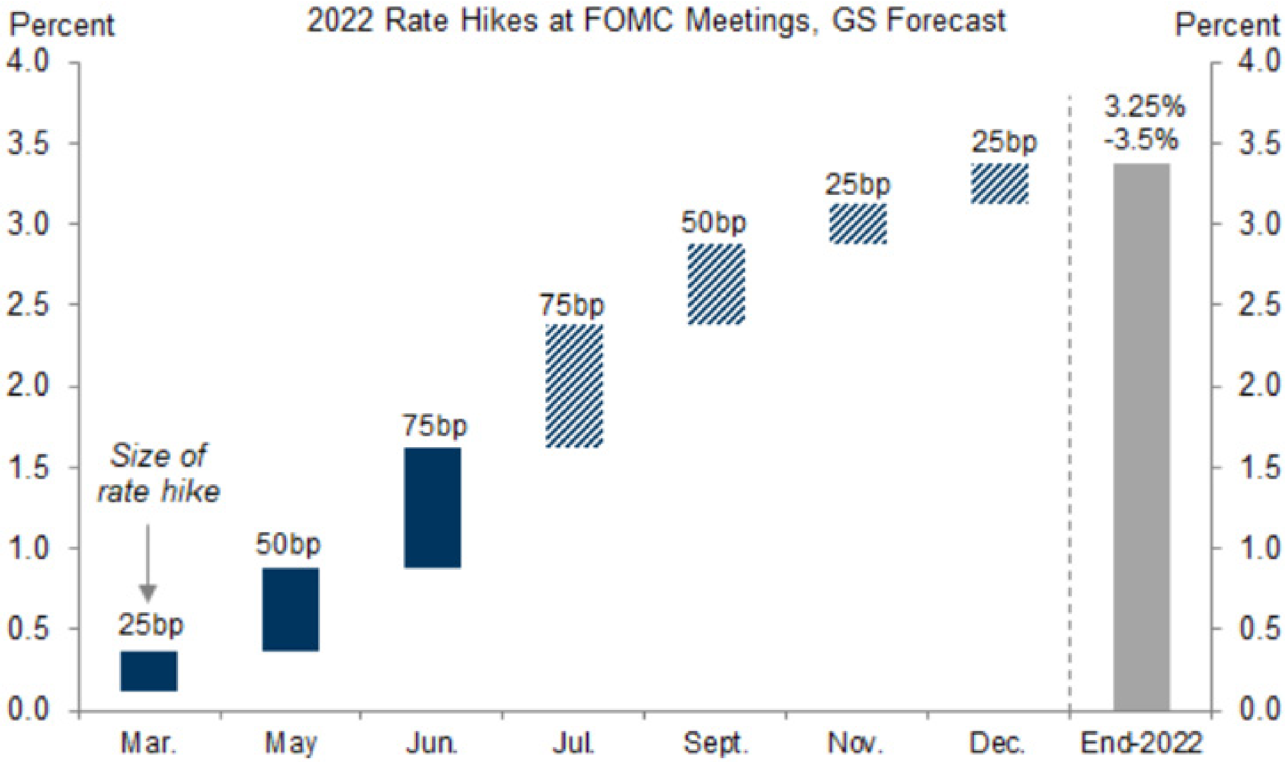
Week in Review

Friday, June 17th, 2022

1. Federal Reserve Accelerates Rate Hikes to Address Inflation

The Federal Reserve delivered a 75-basis point rate hike at its June meeting on Wednesday. Following the higher-than-expected inflation print last Friday, the 75-basis point hike was expected and above the previously discussed 50 basis point hike prior to the inflation print.

The pace of future hikes was also increased for the rest of 2022 with the median dot (average of individual Fed member estimates) projecting a target range for the funds rate of 3.25-3.5% at the end of 2022. While there is more than one way to get there, and some would prefer faster rather than slower, Powell suggested another 75-basis point raise is possible in July.



Source: Goldman Sachs Global Investment Research

Chair Powell offered a balanced message in his press conference. He said that the tightening in financial conditions so far is appropriate and would help to temper growth and rebalance supply and demand. He indicated that he was comfortable with the tightening in financial conditions so far, but also forcefully made it clear that the FOMC is not aiming to induce a recession.

How high the funds rate will ultimately go depends mainly on the path of inflation. Powell reinforced the message that the FOMC needs to see convincing and compelling evidence of inflation coming down and acknowledged that the Committee's decision to hike by 75 basis points had been influenced by the increase in Michigan inflation expectations last Friday and by the rise in the Fed's index of Common Inflation Expectations. He also noted that food and energy prices matter for inflation expectations, meaning that the FOMC must take account of headline inflation as well as core.

A noteworthy change in the Fed's discussion was employment. The Fed now appears to accept that employment will need to soften to bring inflation under control. For the market, this has likely raised the probability for recession, despite Chair Powell's hope that a soft landing can still be orchestrated. This increases the chance that earnings estimates for 2022 and 2023 have likely peaked for the year and downside risk is elevated.

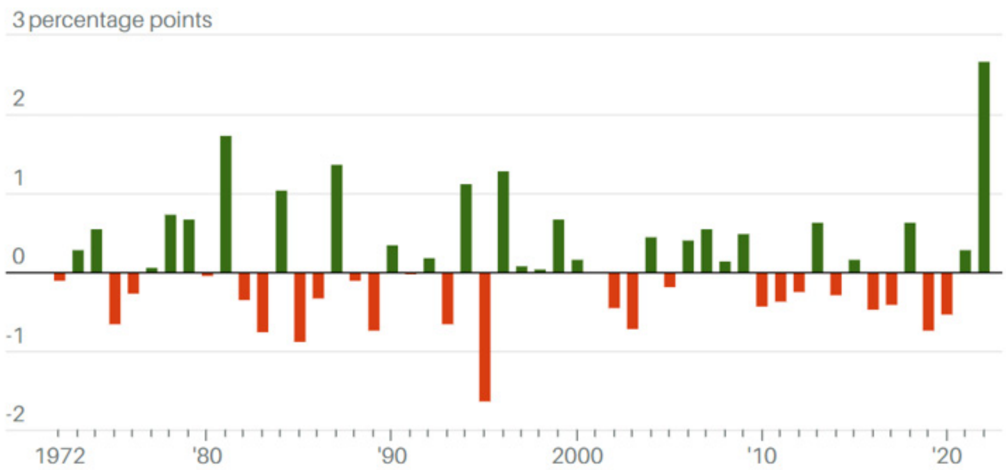
On the positive side, there is generally a belief that the circumstances of high inflation required the more aggressive posture by the Fed, despite the increased risk to growth. Higher rates are expected to contribute to slowing demand and coupled with improved supply chains and anniversary of post Covid spikes in demand should see inflation slow down.

2. Residential Mortgage Rates Reach 15-year highs

In response to the high inflation print and increase in the Federal Funds rate, mortgage rates jumped dramatically this week, posting the biggest weekly increase in 35 years. The average rate on a fixed 30-year loan rose 0.55 percentage points to 5.78% this week, the highest level since November 2008, according to the Primary Mortgage Market Survey from Freddie Mac.

Rates have climbed at a historic pace this year. The rate on a 30-year loan has increased 2.67 percentage points so far this year through June 16, the biggest jump in the history of Freddie Mac's survey over that period, according to Dow Jones Market Data.

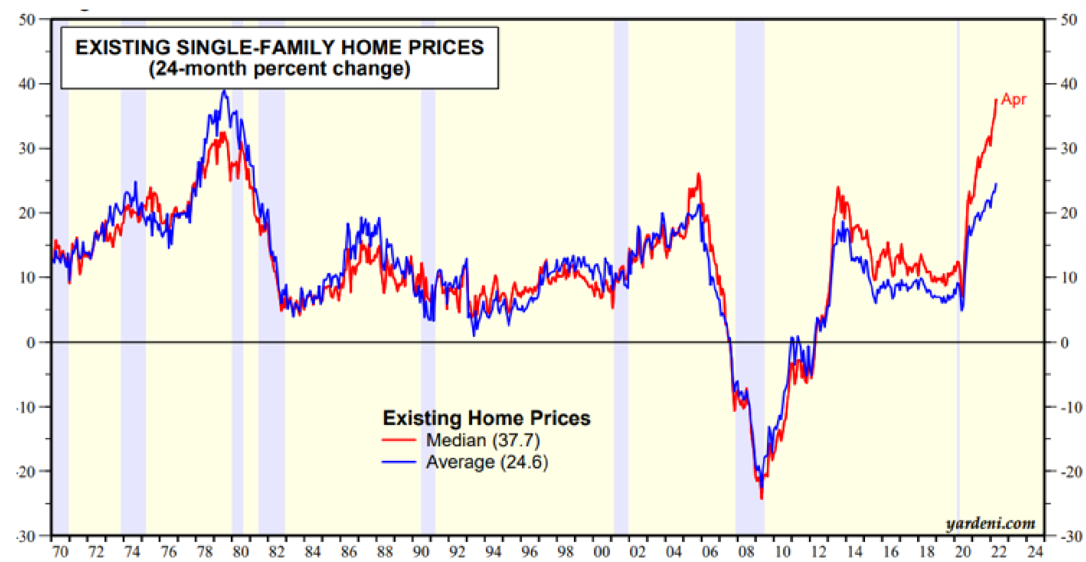
30-Year Fixed Mortgage YTD Change



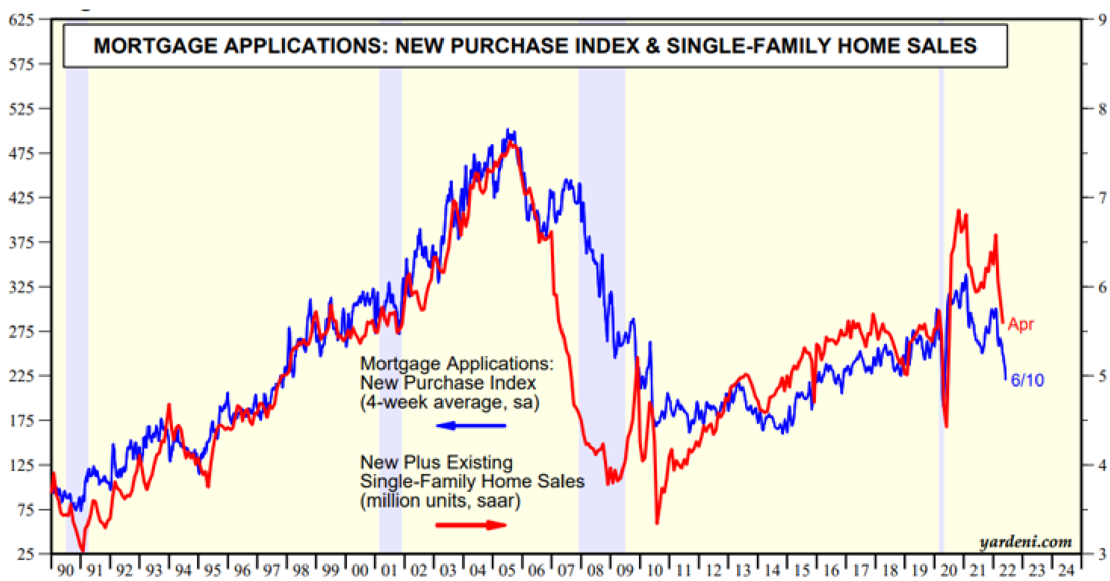
Note: 30-year fixed mortgage.
Source: Freddie Mac.

Rising mortgage rates add pressure to the cost of purchasing a home which is already difficult for many given the price increases which have risen swiftly throughout much of the pandemic. At 5.78%, a 30-year fixed mortgage of $500,000 would cost $632 more a month than it did at the end of 2021, according to a Realtor.com mortgage calculator.

The response to higher mortgage rates is impacting housing which had already been slowing due to lack of supply and high prices. The Mortgage Bankers Association's weekly gauge of mortgage applications showed that applications for a loan to purchase a home last week were 16% below last year's level.



Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: National Association of Realtors.



Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: Mortgage Bankers of America.

Source: Yardeni Research

Housing is also an important underlying driver of the economy from homebuilders, contractors, and retail. Homebuilders' sentiment has turned very negative. The National Association of Homebuilders' index gauging builder confidence declined for the sixth month in a row in June to its lowest reading since the same month in 2020, during the height of the Covid pandemic. May new home construction data, released Thursday morning, added to the sour sentiment. Two gauges of residential home building, housing starts and permits, fell further than expected in May, according to data released by the Census Bureau and Department of Housing and Urban Development.

There are several implications from the housing markets and rates. First, as mentioned, a slowdown will likely be a negative drag on economic growth. Second, potential buyers will likely remain renters putting upward pressure on rental rates. Finally, home prices may need to adjust down to offset the higher mortgage rates. On this final point, history has shown a correlation of a 2-3% price reduction in home prices for every 1% increase in mortgage rates. This year has seen nearly a 3% increase in mortgage rates so far suggesting risk to housing prices, but this is offset to some degree by ongoing low inventory.

Thinking Ahead

The financial markets saw continued weakness this week as the high inflation and poor consumer sentiment data released last week was echoed by the tightening of Fed policy this week and the increasing probability of recession. Near term, there appear to be few visible catalysts to change the negative momentum of the market besides the significant correction that has already taken place. The coming earnings season in July and future data on inflation will be critical for changing the narrative. Expectations are very low, and hopefully can be exceeded. In any case, the current issues in the market can be overcome with time but will require patience.

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

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

WAKEFIELD, MA
701 Edgewater Drive, Ste. 140
Wakefield, MA 01880
781.587.3478

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

PORTSMOUTH, NH
36 Maplewood Ave
Portsmouth, NH 03801
603.292.3699