PALLAS
CAPITAL ADVISORS

Week in Review

Friday, June 24th, 2022

1. Current Economic Growth Data Has Weakened but Green Shoots Exist

Financial markets saw a recovery this week, after the S&P entered a bear market last week, with both a decline in bond yields and positive equity markets. The upward performance came despite worse-than-expected data including the S&P Global US Composite Purchasing Managers Index (PMI) which came in at 51.2, a five-month low and well below expectations. The PMI has an excellent reputation for providing an up-to-date indication of what is happening in the private sector economy by tracking variables such as sales, employment, inventories, and prices.

While still in positive territory (index above 50 still showing expansion), the index was the weakest reading since the Omicron induced slowdown in January and saw the first contraction in manufacturing production in two years during the height of the COVID-19 crisis. While the services component of the index was still positive, the expansion was the slowest in five months.

A spokesperson for the PMI release said that the data is consistent with a material slowing in US economic growth in June to a rate of less than 1%. In addition, he noted that businesses have become much more

concerned about the outlook as a result of the rising cost of living and drop in demand, as well as the increasingly aggressive interest rate path outlined by the Federal Reserve. On the positive side, it was noted that the survey's inflation gauges saw costs and selling prices falling sharply in June suggesting that price pressures, while still elevated, may have peaked.

In the face of growing concerns about slower growth as supported by the PMI, the positive reaction of the financial markets might seem inconsistent. However, while the risk of recession is elevated, some forecasts see economic growth getting stronger in the second half of the year and inflation declining. For example, JP Morgan put out an updated outlook for both Global GDP and CPI this week that suggests improving trends in the second half of 2022, while still acknowledging an elevated risk of recession in the next two years.

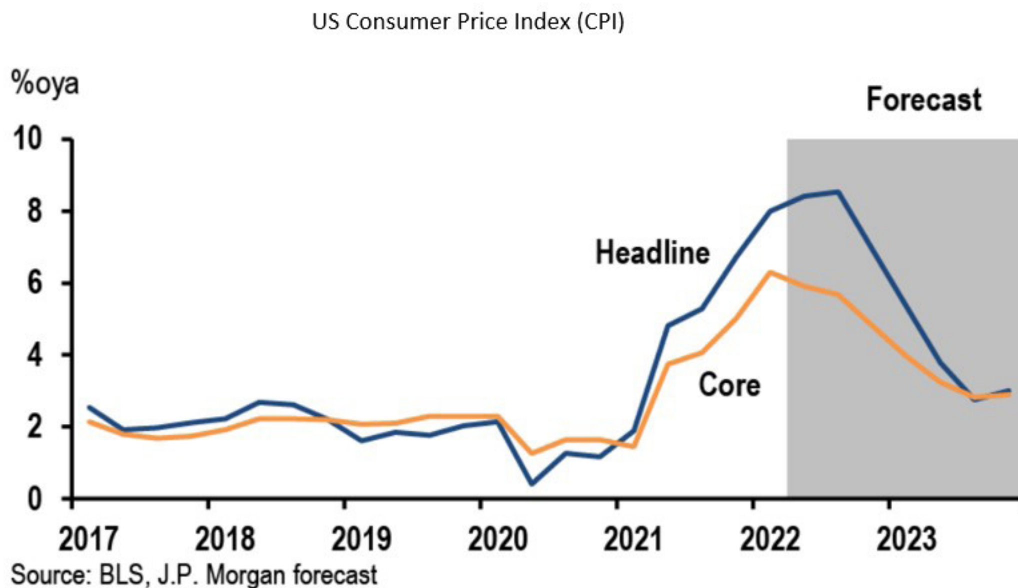
JP Morgan GDP and CPI Forecasts

% change annualized

	--- Real GDP ---			--- Headline CPI ---		
	2022		2023	2022		2023
	1H	2H	4Q/4Q	1H	2H	4Q/4Q
Global (2.6)	1.3	3.1	2.6	9.4	4.2	2.7
DM (1.4)	1.3	2.3	1.7	8.8	4.2	2.2
US (1.5)	0.5	2.0	1.2	9.5	4.4	3.0
Euro area (1.3)	2.4	2.9	2.6	10.1	4.6	1.0
Japan (0.8)	1.7	3.0	1.0	3.1	1.6	1.3
UK (1.0)	0.5	1.3	1.1	11.5	6.2	2.6
EM (4.5)	1.3	4.2	4.1	10.2	4.1	3.6
EM ex China (3.4)	2.0	1.5	3.3	17.6	5.8	5.0
China (5.5)	0.5	7.4	5.1	3.6	2.5	2.4
India (6.0)	6.2	4.2	4.4	8.5	4.5	5.7
EMA ex Chn/Ind (3.0)	3.5	3.6	3.5	6.9	3.8	3.3
Korea (2.7)	1.8	2.7	2.0	7.7	4.4	2.0
EMEA EM (2.5)	-2.4	-1.4	3.4	40.4	9.2	7.9
CEE (3.3)	5.8	2.1	3.9	21.9	9.3	5.4
Russia (1.5)	-12.3	-6.5	2.2	24.7	6.2	5.1
Turkey (3.8)	1.8	0.6	5.6	118.4	16.2	19.7
South Africa (1.3)	3.4	1.2	1.9	6.6	7.4	4.4
Latam (1.9)	1.8	0.0	2.0	9.3	4.8	4.2
Mexico (2.2)	2.8	1.6	1.4	8.3	5.7	3.9
Brazil (1.5)	2.8	-1.8	1.9	9.4	3.9	4.5

Source: J.P. Morgan Global Economics. Pre-pandemic potential in parentheses

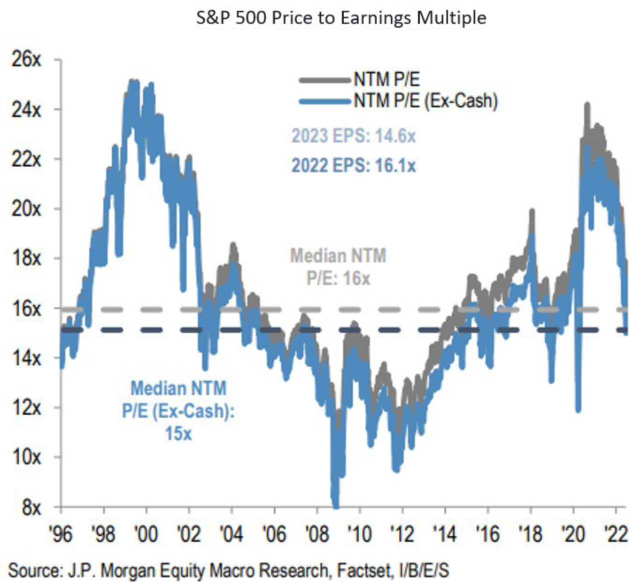
Notable in JP Morgan's forecast is an acceleration in global real GDP in the second half of 2022 from 1.3% in the first half of the year to 3.1% in the second half, before resuming the pre-pandemic growth trend of 2.6% in 2023. They also forecast inflation (CPI) declining to nearly half the present rate by the end of the year and falling further in 2023. A significant driver of the global recovery is the forecast recovery in China following their ongoing COVID closures. Their forecast for US GDP and inflation are also positive, albeit GDP growth below history after a second half recovery and inflation remaining above trend as well.

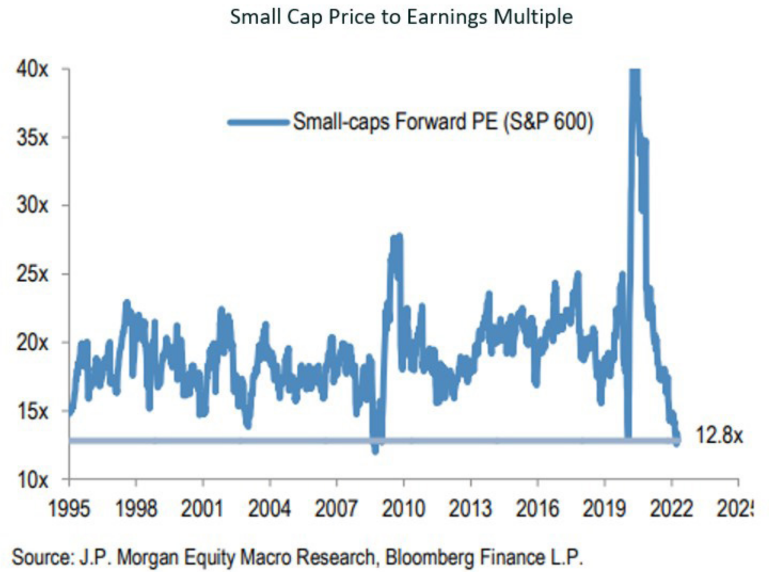


On the back of their forecasts, JP Morgan is very optimistic about the potential for a financial market recovery in 2022. Perhaps a positive turn is coming for economic growth, reacceleration in the second half of the year, and lower inflation. However, we look for more data to come from the upcoming corporate earnings season and confirmation that inflation and the Federal Reserve's response and policy reestablish equilibrium.

2. Valuation Multiples and Sector Sentiment May Already Reflect a Recessionary Scenario

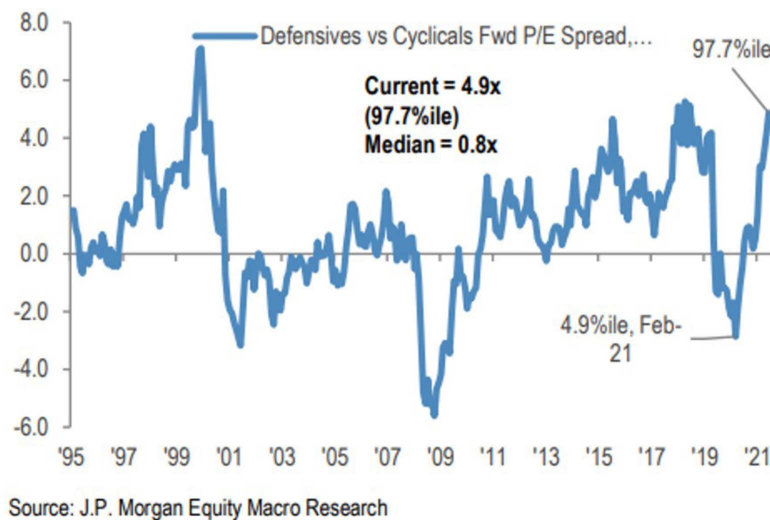
The market correction this year has resulted in valuations based on expected earnings to adjust dramatically downward. For the S&P 500, the forward price to earnings ratio (P/E) is now below the historical average of the last 15 years. For the small cap S&P 600 index, the P/E is trading near a 15-year-low seen only at the worst of the financial crisis in 2008/2009.





While the level of valuation is arguably attractive, concerns exist that the expectations for earnings are too high. In this camp, the fear is that the market can still fall further to adjust for lower earnings. In the truly fearful camp is that not only earnings will fall, but inflation and low growth prospects (stagflation) will continue to push valuation multiples lower.

This elevated level of fear of recession and inflation has pushed the spread between P/E multiples for defensive versus cyclicals to near record levels. The expectation is that earnings of cyclical businesses is too high and therefore they trade at low multiples, while defensives trade at a market premium for their perceived stability.



This dynamic is not necessarily wrong if there is a recession that substantially undermines the earnings power of cyclical businesses. However, by its existence, the high level of spread for defensives versus cyclicals has arguably already priced in a very high probability of recession.

Among the more cyclical areas of the economy is transportation. As a proxy, the SPDR S&P 500 Transportation ETF is down 28% year-to-date, driven by multiple contraction to its current level of 10X as earnings for the year have remained relatively flat. The largest component of the index is the Federal Express (FDX). FDX reported earnings on Thursday night this week and raised its guidance for the next year above expectations and more than 10% above the trailing year basis. As canary of the economy, perhaps this bodes well given the general low level of valuations and particular aversion to quality cyclical stocks.

Thinking Ahead

The financial markets broke the down trend this past week with a rally in both equities and fixed income. A high level of concern about recession and inflation has been priced into the market, a position supported by recent CPI and PMI data and more aggressive Federal Reserve action. However, it is also possible that the pace of negative data may abate in the second half of the year and by some forecasts potentially even improve (better growth and lower inflation). It is likely too soon to draw definitive conclusions, but in any case, a significant amount of downside has likely been priced into the financial markets.

Maintaining a balanced, disciplined approach with a diversified portfolio invested in quality, profitable businesses should be rewarded with time.

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

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.

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

NEWPORT, RI
51 Long Wharf Mall
Newport, RI 02840
401.847.0505