PCA Quarterly Commentary

Q2 2022

Second Quarter Performance, Outlook for Remainder of Year

The second quarter of 2022 saw an accelerated deterioration in financial markets, following a weak first quarter, resulting in the worst first half of a year's performance in decades. This Pallas Capital Advisors Q2 2022 commentary will discuss markets, economics, and government actions to judge the implications for equities, bonds, and private markets. We will also discuss some potential market drivers for the remainder of 2022.

The core driver of financial markets in the first half of 2022 was the onset of the worst inflation in 40 years. The ongoing snapback in demand post-COVID, the impact of loose fiscal and monetary policy, supply chain disruptions, and the spike in oil prices following Russia's invasion of Ukraine resulted in the Consumer Price Index (CPI) posting an 8.6% year-over-year increase in May. Following last year's hope for inflation being transitory, the current rate is well ahead of the Federal Reserve's long-term target of 2%. This elevated inflation level has been met with an aggressive response by the Federal Reserve in raising interest rates and a plummet in consumer confidence. Both responses prompted a contraction of valuation multiples and fear of slower prospective earnings growth or eventual recession-driven negative earnings revisions.

Global Markets Summary

	S&P 500	Russell 2000	MSCI Core Developed Ex US	MSCI Emerging Markets	Barclays US Aggregate Bond	Barclays US High Yield VLI Bond
Q2 2022	-16.1%	-17.3%	-13.6%	-10.4%	-4.7%	-10.0%
YTD 2022	-20.0%	-23.5%	-19.8%	-17.4%	-10.3%	-14.1%

Source: Orion

Annual Returns						Monthly Returns						
2016	2017	2018	2019	2020	2021	Jan 2022	Feb 2022	Mar 2022	Apr 2022	May 2022	Jun 2022	YTD 2022
Small Cap Equity 21.31%	Emerging Market Equity 37.28%	U.S. Fixed Income 0.01%	Large Cap Equity 31.49%	Small Cap Equity 19.96%	Large Cap Equity 28.71%	Emerging Market Equity -1.89%	Small Cap Equity 1.07%	Real Estate 4.47%	High Yield -3.56%	Dev ex-U.S. Equity 0.83%	U.S. Fixed Income -1.57%	U.S. Fixed Income -10.35%
High Yield 17.13%	Dev ex-U.S. Equity 24.21%	High Yield -2.08%	Small Cap Equity 25.52%	Large Cap Equity 18.40%	Real Estate 26.09%	Global ex-U.S. Fixed Income -1.96%	High Yield -1.03%	Large Cap Equity 3.71%	U.S. Fixed Income -3.79%	U.S. Fixed Income 0.64%	Global ex-U.S. Fixed Income -4.50%	High Yield -14.19%
Large Cap Equity 11.96%	Large Cap Equity 21.83%	Global ex-U.S. Fixed Income -2.15%	Dev ex-U.S. Equity 22.49%	Emerging Market Equity 18.31%	Small Cap Equity 14.82%	U.S. Fixed Income -2.15%	Global ex-U.S. Fixed Income -1.11%	Small Cap Equity 1.24%	Real Estate -5.48%	Emerging Market Equity 0.44%	Emerging Market Equity -6.64%	Global ex-U.S. Fixed Income -16.49%
Emerging Market Equity 11.19%	Small Cap Equity 14.65%	Large Cap Equity -4.38%	Real Estate 21.91%	Global ex-U.S. Fixed Income 10.11%	Dev ex-U.S. Equity 12.62%	High Yield -2.73%	U.S. Fixed Income -1.12%	Dev ex-U.S. Equity 1.16%	Emerging Market Equity -5.56%	High Yield 0.25%	High Yield -6.73%	Emerging Market Equity -17.63%
Real Estate 4.06%	Global ex-U.S. Fixed Income 10.51%	Real Estate -5.63%	Emerging Market Equity 18.44%	Dev ex-U.S. Equity 7.59%	High Yield 5.28%	Dev ex-U.S. Equity -4.41%	Dev ex-U.S. Equity -1.56%	High Yield -1.15%	Dev ex-U.S. Equity -6.57%	Large Cap Equity 0.18%	Small Cap Equity -8.22%	Dev ex-U.S. Equity -18.76%
Dev ex-U.S. Equity 2.75%	Real Estate 10.36%	Small Cap Equity -11.01%	High Yield 14.32%	U.S. Fixed Income 7.51%	U.S. Fixed Income -1.54%	Large Cap Equity -5.17%	Real Estate -2.47%	Emerging Market Equity -2.26%	Global ex-U.S. Fixed Income -6.83%	Small Cap Equity 0.15%	Large Cap Equity -8.25%	Large Cap Equity -19.96%
U.S. Fixed Income 2.65%	High Yield 7.50%	Dev ex-U.S. Equity -14.09%	U.S. Fixed Income 8.72%	High Yield 7.11%	Emerging Market Equity -2.54%	Real Estate -5.75%	Emerging Market Equity -2.99%	U.S. Fixed Income -2.78%	Large Cap Equity -8.72%	Global ex-U.S. Fixed Income 0.01%	Real Estate -8.69%	Real Estate -20.72%
Global ex-U.S. Fixed Income 1.49%	U.S. Fixed Income 3.54%	Emerging Market Equity -14.57%	Global ex-U.S. Fixed Income 5.09%	Real Estate -9.04%	Global ex-U.S. Fixed Income -7.05%	Small Cap Equity -9.63%	Large Cap Equity -2.99%	Global ex-U.S. Fixed Income -3.20%	Small Cap Equity -9.91%	Real Estate -4.35%	Dev ex-U.S. Equity -9.41%	Small Cap Equity -23.43%

Sources: Bloomberg Aggregate • Bloomberg Corp High Yield • Bloomberg Global Aggregate ex US • FTSE EPRA Nareit Developed • MSCI World ex USA • MSCI Emerging Markets • Russell 2000 • S&P 500

Source: Callan Institute

The S&P 500 is now down 20.0% for the year, its worst first-half performance since 1970. Other parts of the market have seen an even worse performance with the small-cap benchmark Russell 2000 index down 23.5%, its worst first half since the index's inception in 1984. The tech-heavy NASDAQ Composite has fallen 29.5%, the worst first-half performance since its inception in 1971. Global markets have also been weak with the MSCI Core Developed ex U.S. down 19.8% and MSCI Emerging markets down 17.4%.

Weakness was not confined to equity markets with the U.S. Aggregate Bond Index contracting by 10.3%, its worst performance since its inception in 1973, and credit concerns driving the high yield bond index down 14.1%. The occurrence of a dual decline in stocks and bonds was only the third time in more than four decades that stocks and bonds both posted losses for two consecutive quarters. The last time was in 2008 during the financial crisis and before that was 1981 when the Federal Reserve was also raising rates to combat inflation.

While defensive sectors and energy held up better than the overall market, all sectors of the equity markets posted negative returns in the second quarter. The collapse in consumer confidence was particularly felt in the worst performing sectors, including consumer cyclical, technology, and communication services.

U.S. Equity Sector Performance

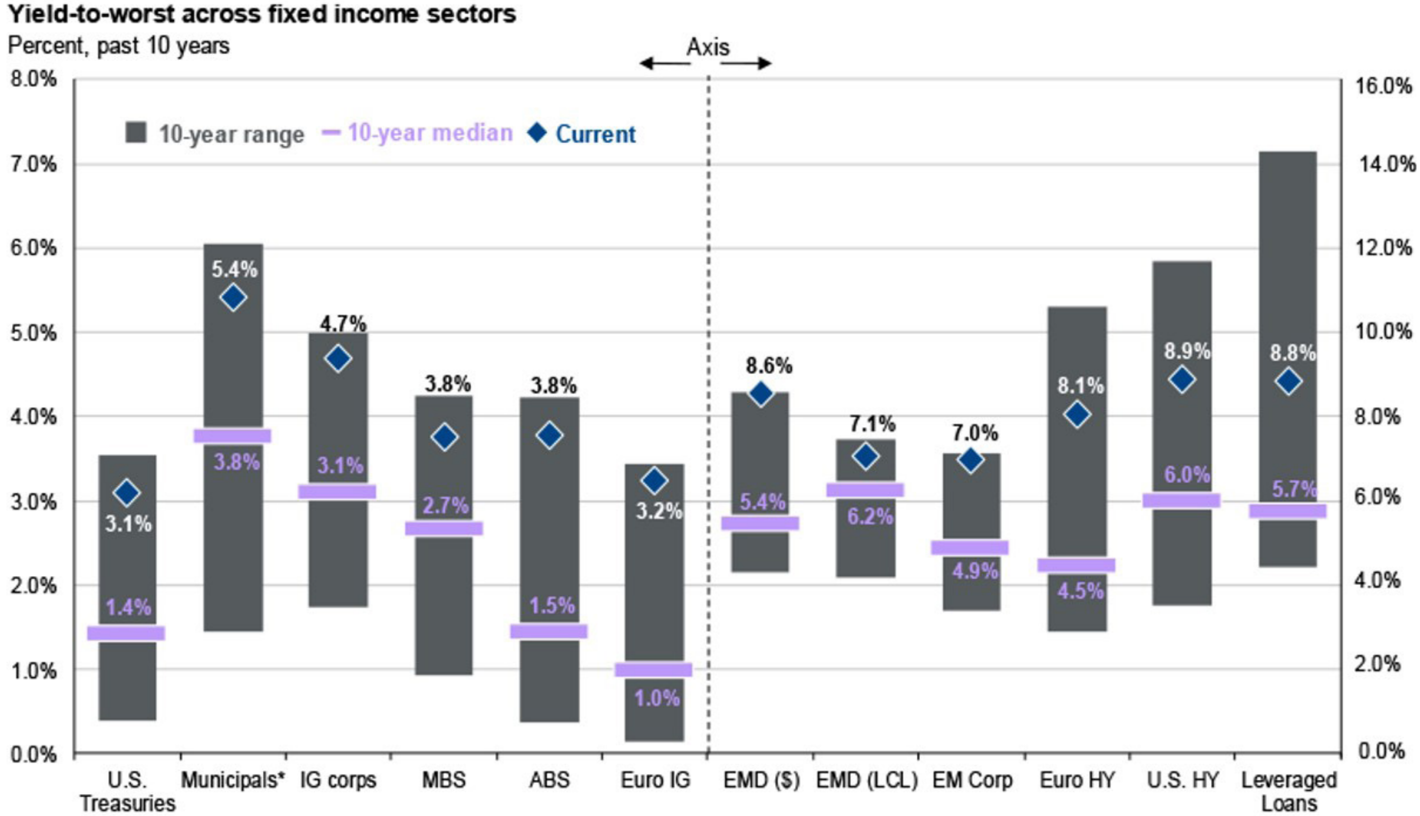
	Performance %		
Cyclical	**Q2 2022**	**Q1 2022**	**2022 YTD**
Basic Materials	-17.53	-1.29	-18.59
Consumer Cyclical	-25.19	-10.66	-33.17
Financial Services	-17.13	-3.01	-19.62
Real Estate	-15.01	-6.22	-20.30
Sensitive			
Communication Services	-21.89	-12.20	-31.41
Energy	-5.96	38.47	30.21
Industrials	-15.24	-3.82	-18.48
Technology	-22.33	-9.66	-29.83
Defensive			
Consumer Defensive	-5.70	-1.31	-6.93
Healthcare	-7.07	-4.03	-10.82
Utilities	-5.07	4.48	-0.82

Source: Morningstar Direct, Morningstar Indexes. Data as of June 30, 2022.

Similar to equities, the primary shock to the bond market was the rapid rise in interest rates. The Federal Reserve raised interest rates twice during the quarter and in both cases at higher successive amounts. After raising the Fed Funds rate by 25 basis points in March, the Fed raised rates by 50 basis points in May and then 75 basis points in June. As would be expected, longer-duration bonds felt the brunt of the sell-off from higher rates. The 10+ year Treasury Bond Index was off -11.6% for the quarter and -20.9% for the year-to-date.

Credit has so far remained in good shape, but growing fears of recession as the quarter finished raised credit spreads from historical lows back to the longer-term average. Fear of recession has also flattened the yield curve. The 10-year U.S. Treasury peaked at 3.5% in June but finished the quarter at 3.2% (up from 1.5% at the end of 2021). Meanwhile, the 2-year U.S. Treasury finished the quarter at 3.1% (up from 0.73% at the end of 2021) and close to the 10-year yield. Subsequent to the end of the quarter, the yield curve inverted this past week. The drop in longer-term yields at the end of the quarter dampened the bond sell-off as markets adjusted to expectations for slower growth and some initial data points indicating some easing of inflationary pressures.

On a positive note, the level of yields for fixed income at the end of the quarter had risen well off the lows from 2021 and now are close to their high marks for the past 10 years. The bond market has been relatively swift to price in the impacts of the current higher inflation and Fed Funds rates. Bonds ended the quarter better positioned for income generation with appreciation potential if inflation were to revert to the levels of the past two decades and are in line with the Federal Reserve's long-term target.



Source: J.P. Morgan

International equity markets outperformed the U.S. markets in the second quarter, although they remained weak. Performance in international markets has likely been supported by structurally lower valuation multiples versus the U.S. market but offset by strong appreciation of the dollar (a strong dollar weighs negatively of the conversion of international share prices). Fundamentally, most developed markets (Europe) are expected to see a greater negative impact from the war in Ukraine with the spike in energy prices. Emerging markets saw a boost in the second quarter as the China market outperformed relatively on hopes for its reopening after strict closures from COVID and additional stimulus measures.

As fundamentals have largely remained intact to date, private markets have largely outperformed their public counterparts for the quarter and year-to-date. The lower volatility of private markets has benefited performance in this year's down market as valuations are determined with a longer-term view than public markets which can be subject to short-term trading, liquidity and sentiment. We would expect convergence of valuation metrics overtime with public markets to reflect normalized macro drivers such as economic growth and interest rates.

Market Outlook - Q2 2022

Following the historical level of negative equity and bond performance in the first half of 2022, financial markets have made a significant adjustment to incorporate higher rates and slower growth environment. With an expected terminal rate for the Federal funds rate between 3.0% – 3.5%, equity multiples and bond yields have likely ground out much of the pain. The S&P forward P/E ratio has dropped from over 22X in 2021 to finish under 16X at the end of the second quarter. At 16X the multiple is now in-line with the 25-year average, albeit well above trough levels experienced during and post the financial crisis of 2008 and 2009. Meanwhile, the 2-year U.S. Treasury finished at a yield of 3.1%, up from 0.2% or a delta of 2.9% from one year ago.

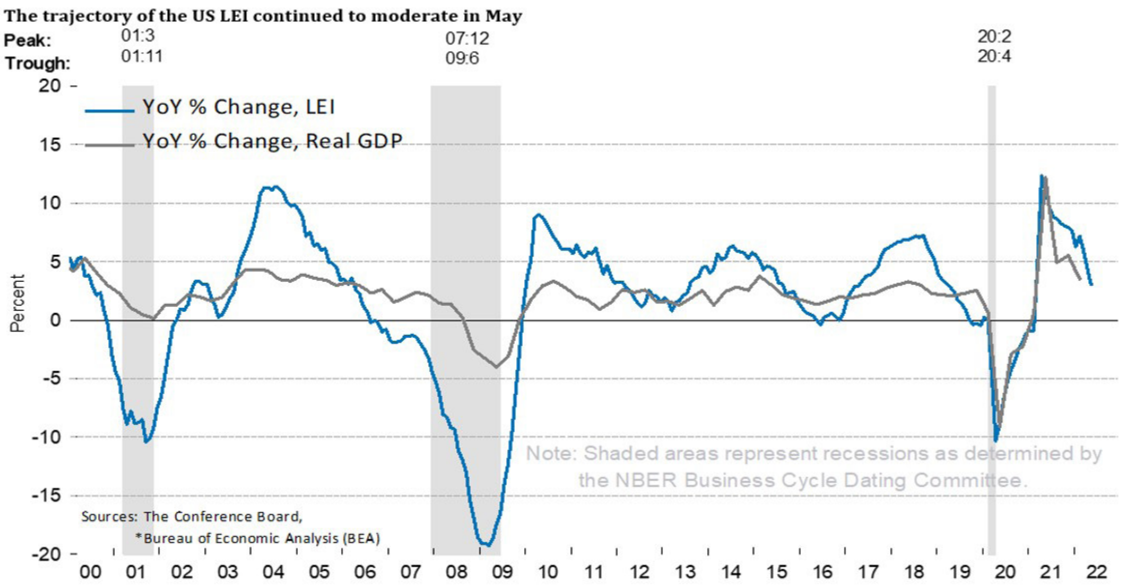
Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	15.94x	16.85x	-0.27
CAPE	Shiller's P/E	28.74x	28.01x	0.11
Div. Yield	Dividend yield	1.76%	1.99%	0.70
P/B	Price to book	3.36x	3.10x	0.32
P/CF	Price to cash flow	12.14x	11.16x	0.45
EY Spread	EY minus Baa yield	0.93%	0.22%	-0.36

Source: J.P. Morgan

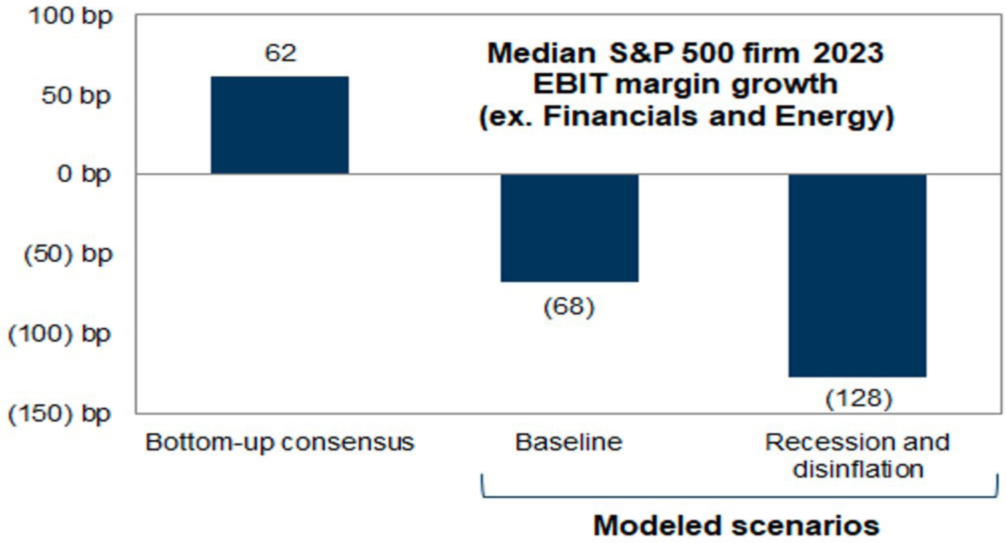
While there is some risk that inflation will remain stubbornly high and pressure the Federal Reserve to increase rates beyond the current expected terminal level latter in 2022 and 2023, there is also the possibility that inflation will subside more quickly than expected easing pressure on valuation metrics for equities and bonds. Supporting the latter, recent data seen in lower oil prices, lower prices for commodities including copper, steel, lumber, and grain, softer housing data, and some softening of labor demand support that peak inflation may have, or will shortly, pass. However, the payback for lower inflation could be slower growth or recession.

The case for a recession has risen. As mentioned above, the 10-year to 2-year Treasury inverted this week for the second time in three months. Over the past 50 years, the curve has inverted six times, and six recessions followed. However, the curve inversion does not predict timing. The amount of time between inversion and recession has ranged from 8 months to 35 months with an average of 20 months.

Other factors beyond a yield curve inversion often set the preconditions for recession including deterioration of leading economic indicators (LEI), corporate profit erosion, and weakening labor markets. The first of these, LEI, has seen growth roll over meaningfully in 2022, although it has yet to go negative.



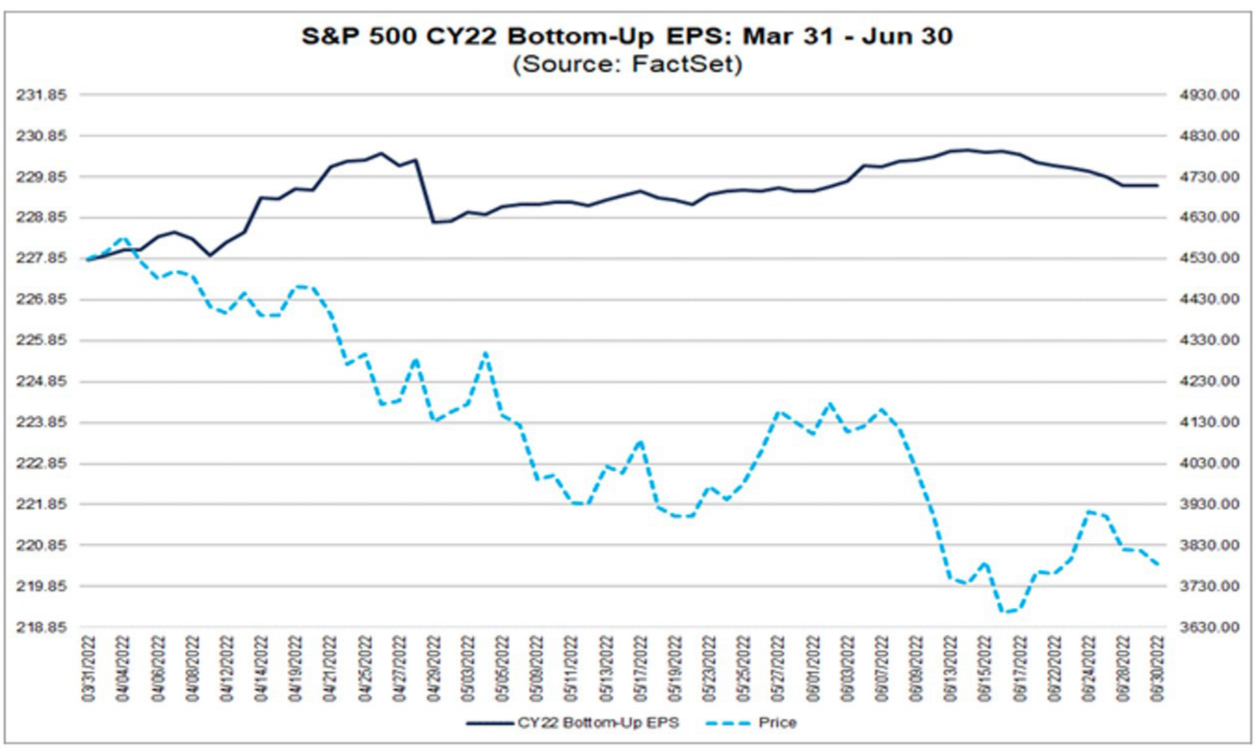
The next factor, corporate profit margins, has to date held up. Looking back, despite higher input, labor, transportation, and other costs, companies have successfully passed on the higher costs to their end markets as demand has been strong and supply has been constrained. This environment to pass on costs is expected to have deteriorated in the second quarter, as several large retailers have already announced, and may worsen as demand wanes and supply overcomes last year's bottlenecks. Actual data is still limited, but Goldman Sachs put out a research piece on this topic last week. The Goldman analysis sees the erosion of margins under both a baseline economic scenario and worse under a recession scenario. Meanwhile, Goldman's research indicates analyst consensus estimates reflect continued expansion of margin in 2023.



Source: FactSet, Goldman Sachs Global Investment Research

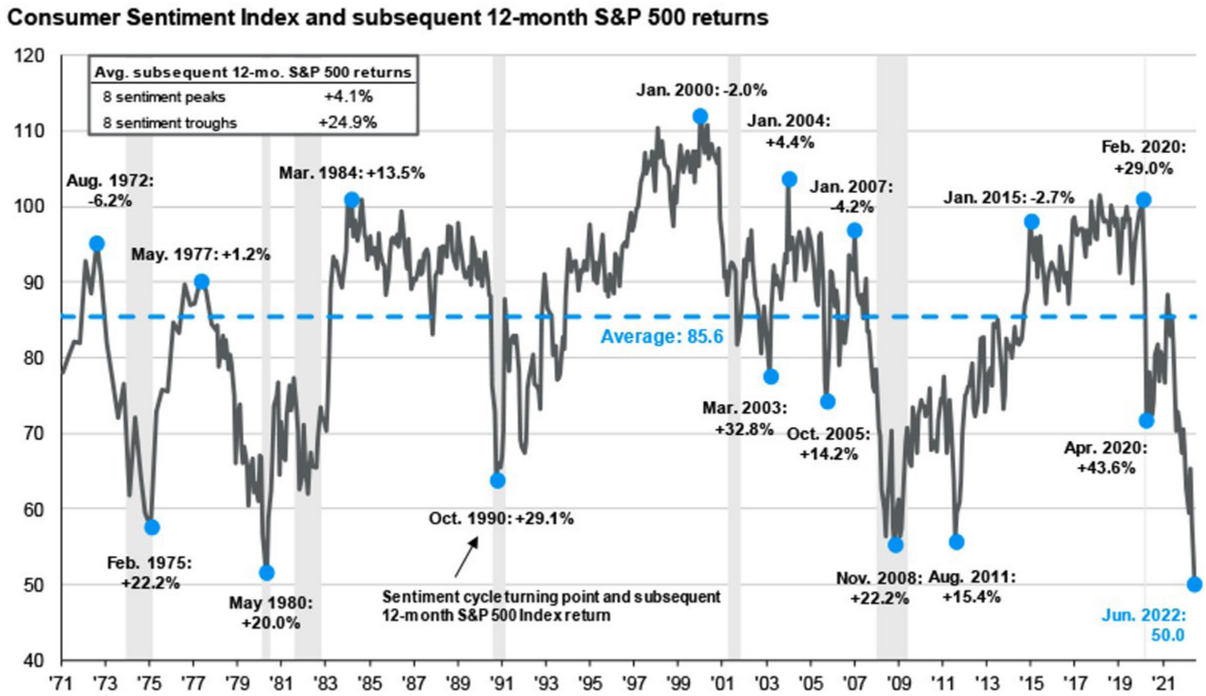
The final factor is employment. Currently, this factor is strong with unemployment at record lows and more job openings than potential employees to fill them. However, the strength of the labor market and the associated wage growth is a contributor to inflation and potentially in the cross hairs of the Fed. While the Fed has a dual mandate to maintain stable prices and employment, its focus at this point is on controlling high prices, and meanwhile, its target for unemployment at 4% is above the current level of 3.6%. While still strong, initial claims for unemployment increased to a 16-month high in June but are expected to cool in the next few months.

The growing thought that a recession seems inevitable appears to be the consensus, although there is disagreement about the timing and severity. However, consensus corporate earnings forecasts are not seen as reflecting the high risk of recession. While the market has seen a record decline in 2022, the decline in stocks has been fully due to multiple compression. The negative 20% return for the S&P 500 has been comprised of a 27% decline in the forward P/E, while the consensus earnings estimate for the year increased by 7%. Not only have 2022 earnings forecasts gone up, but projections for 2023 stand 9% above 2022.



The possibility that corporate earnings will be revised downward in the coming months is high as companies will likely be conservative given macro (economy) and micro (margin) headwinds and the probability of recession has risen. However, in parallel with the increased expectation of slower growth/recession is the potential for lower inflation as an offshoot. The dynamic of the two potentially has offsetting implications for the market with lower earnings offset by a potential cap on the Federal Funds terminal rate, despite ongoing rate increases to get to that level, providing support to equity valuation multiples and current bond yields.

In summary, we believe in being clear-eyed about what lies ahead in terms of the potential for a recession and negative impact on corporate earnings as well as the Federal Reserve's imperative to defeat inflation and implication for interest rates. However, we are entering this period of uncertainty with several strengths including healthy corporate and personal balance sheets, a strong employment market, and ongoing economic normalization following the COVID disruptions that may help to dampen any downturn. Finally, the amalgamation of issues such as COVID hangover, broad-based inflation, high mortgage rates in a tight housing market, the Ukraine War, and global and national geopolitical disruption have caused consumer sentiment to hit trough levels often coincident with recessions, but also a historical precedent to strong financial markets returns in the subsequent 12 months.



Source: J.P. Morgan

While future returns may not follow historic precedent, the financial markets have chopped a lot of wood on the downside this year. We believe that quality companies with attractive business models, profitability, solid balance sheets, and growth and improvement prospects are well-positioned following periods of market pullbacks to deliver attractive relative returns prospectively.

Conclusion

2022 is off to an historically weak first half for financial markets, with both equity and bond markets repeating a second consecutive quarter of negative returns. The overriding driver of the volatility has been historically high inflation and an aggressive Fed response in raising rates. Corporate earnings of proven, quality companies have remained resilient overall, but the conditions for a recession and lower corporate earnings have been seeded.

The downturn in the markets has likely absorbed much of the expected movement higher in interest rates assuming inflation has peaked. On the positive side, the root causes of inflation should be able to be addressed by economic normalization as the Fed's increase of rates addresses demand, and supply normalizes following COVID, supply chain, and war disruptions. However, concerns rightly exist as to the potential impact on corporate earnings from slower growth or recession.

Finally, sentiment is very negative, which has historically been correlated with positive future returns, although past performance is not a guarantee of future returns. In any case, a sound, diversified investment strategy incorporating focus on exposure to businesses with proven growth, resilience and profitability should navigate the choppy waters of 2022.

Pallas Capital will continue to focus on quality, long-term investments, including private markets, to help clients achieve their goals.

Sincerely,

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