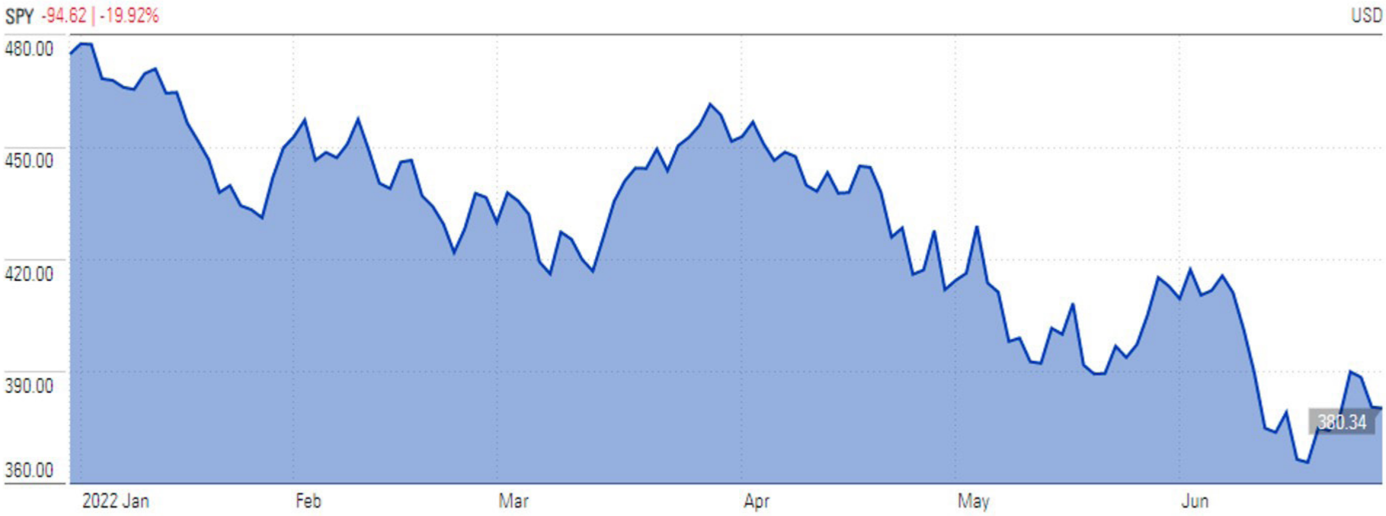
PALLAS
CAPITAL ADVISORS

Week in Review

Friday, July 1st, 2022

1. Equity Markets Experience a Historically Tough First Half

U.S. stocks declined in June capping the worst first-half performance since 1970 with a decline of approximately 20% for the S&P 500. Other major indices have also declined with the Dow and NASDAQ Composites posting negative 15% and 30%, respectively.



Source: Morningstar

For June, the S&P 500 declined nearly 8% with all eleven sectors having monthly losses. As fears of recession have grown, the cyclical energy, materials and financial sectors have been among the worst performers in June. With respect to energy, this is a reversal of its relative strong performance year-to-date. Relative outperformance for June has turned to more defensive sectors and companies with quality attributes such as strong balance sheets, high ROE, and cash flow.

Disappointing equity performance has been driven by a decline of valuation multiples. The primary driver of this decline has been the rapid rise in the 10-year Treasury yields.

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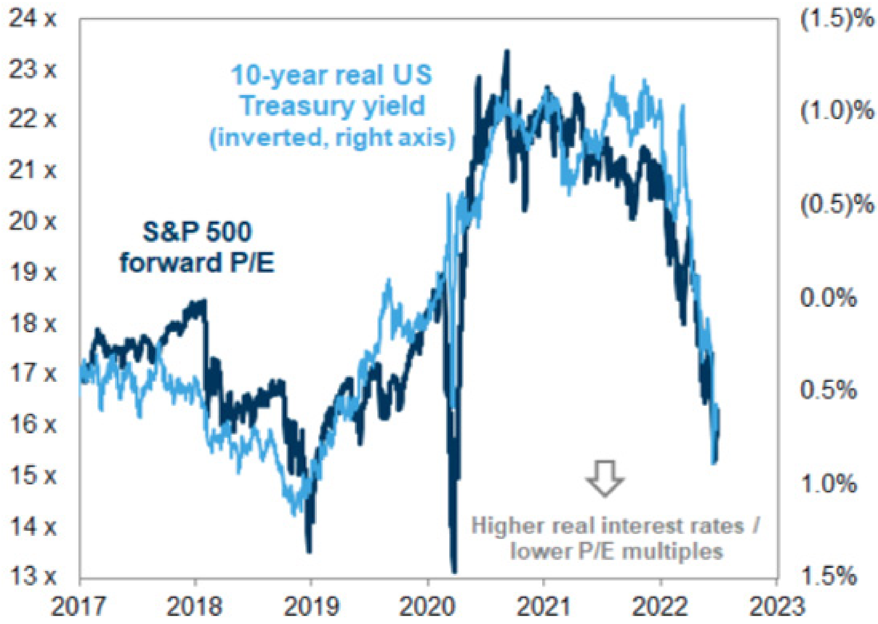
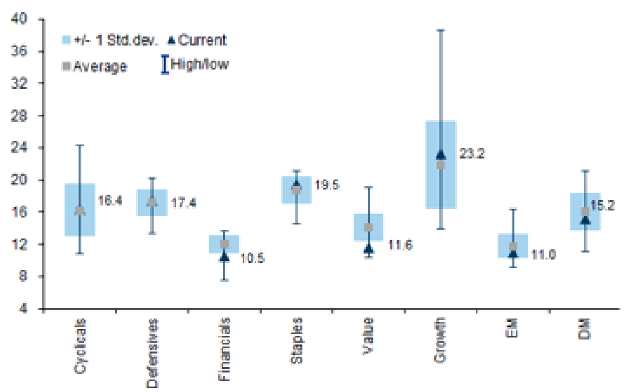


Source: Goldman Sachs

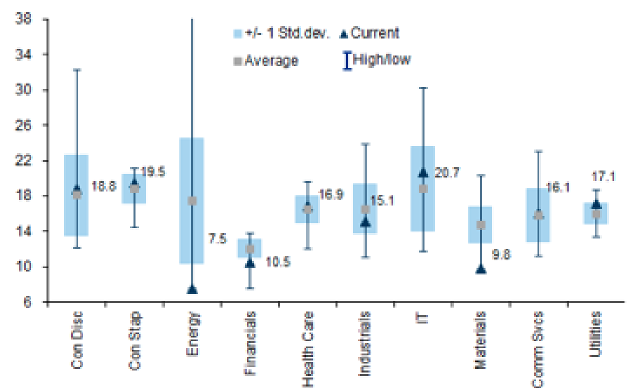
Whether on a style basis (e.g., growth versus value) or sector basis (e.g., staples versus technology), forward price to earnings ratios (P/E) are now reasonable from a long-term historical perspective.

Style Forward P/E



Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research

MSCI Sector Forward P/E

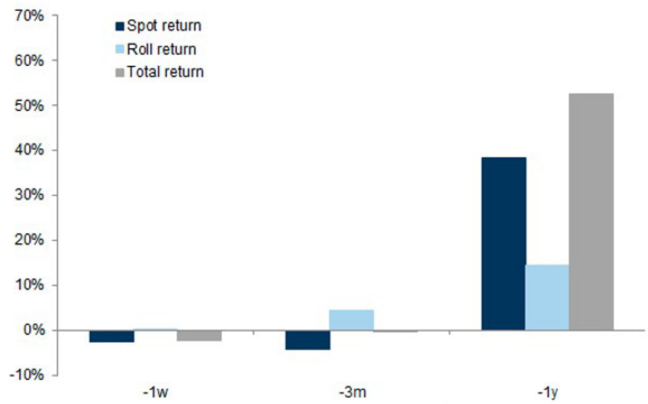


Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research

At this juncture, risk to further valuation compression is principally from higher long-term interest rates, a risk predicated upon a rise in long-term expectations for inflation. Inflation running currently at a 40-year high has been a major headwind to financial markets. However, recent data points in commodities are starting to suggest that the peak may have been reached and long-term expectations are for substantial further slowing. For example, the Goldman Sachs Commodity Index shows a decline in June led by a fall in industrial metals and agriculture. Energy costs also plateaued in June and while a substantial decline is not likely given the current war in Ukraine, the shock of an 82% increase in the past year is unlikely to be repeated.

Goldman Sachs Commodity Index

Returns over the past 1 week, 3 months and 1 year



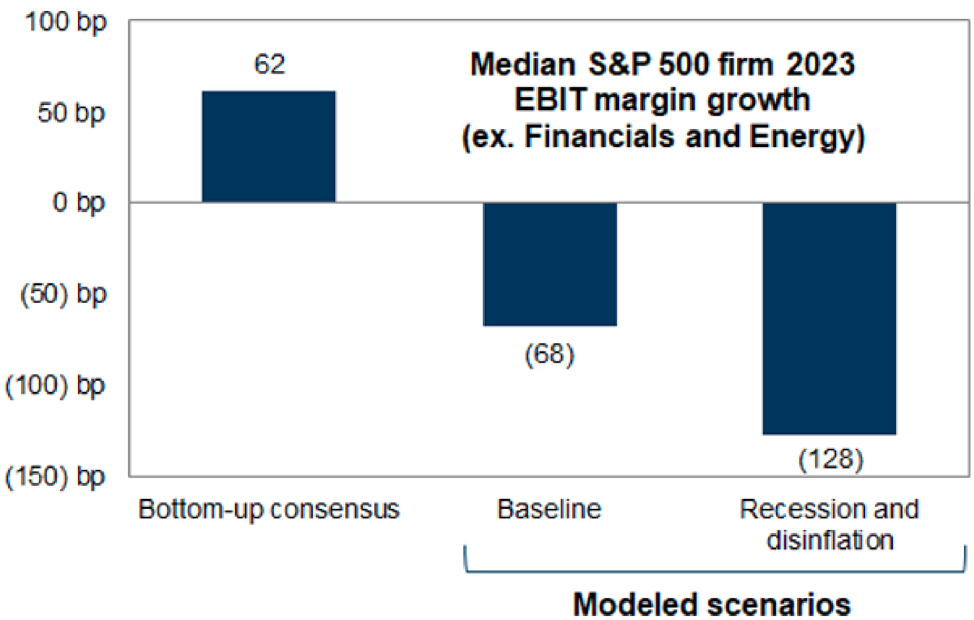
Source: Datastream, Goldman Sachs Global Investment Research

Weight signifies contribution to the GSCI® Enhanced index

	Current Weight (%)	Returns (%) -1w	-1m	-1y
S&P GSCI Enhanced	**100.0**	**-2.5**	**-2.5**	**52.0**
Energy	66.3	-0.8	0.9	81.8
Industrial Metals	8.4	-5.3	-12.4	-2.3
Precious Metals	3.7	-0.7	-1.3	-0.2
Agriculture	16.3	-8.1	-10.7	33.9
Livestock	5.3	-1.3	0.8	0.6

Source: Goldman Sachs, Goldman Sachs Global Investment Research

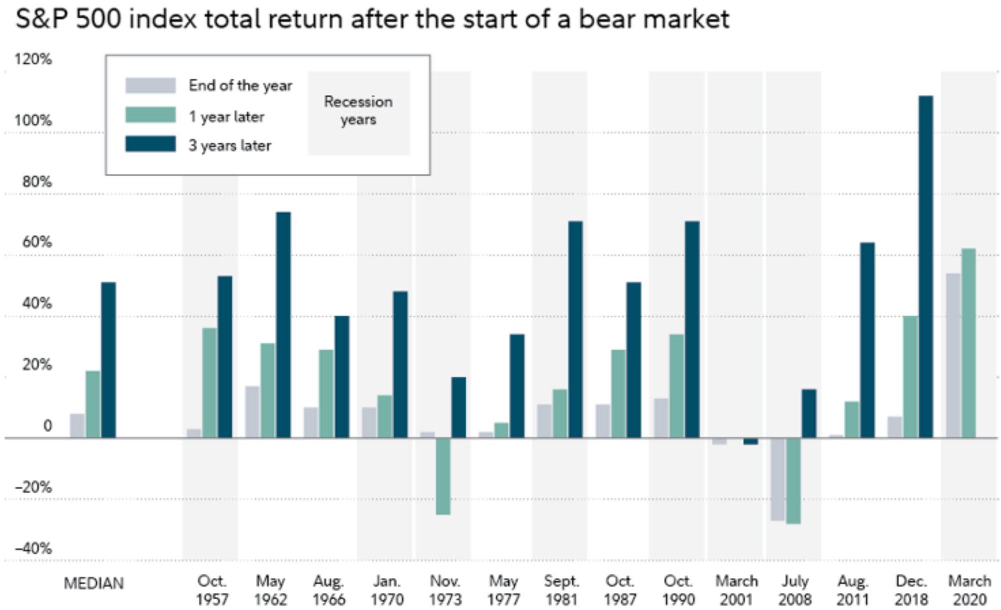
The key risk to the markets looking forward is negative earnings revisions and potential for recession. To date, U.S. earnings revisions have been positive at an aggregate level. However, investors are increasingly skeptical that earnings expectations will be sustainable. Goldman Sachs put out a piece this week that suggested analyst estimates are potentially too optimistic with respect to operating margins which continue to model improvement. Their analysis projects a decline in margin under a baseline growth scenario and further deterioration in a recession scenario.



Source: FactSet, Goldman Sachs Global Investment Research

Such a decline in operating margin would be a major headwind to earnings, although the inflationary benefit to revenues may offset a portion of the negative margin impact.

While the correction in the market has likely factored in some deterioration in earnings, it is hard to say the bottom has been put in until there is greater clarity in future earnings power, as well as stability in interest rates, given their influence on multiples. However, with the benefit of time, history has shown strong returns following the start of bear markets. This suggests the benefit of remaining invested despite the risks and uncertainties that exist in the current environment.



Source: Bloomberg Finance, LP

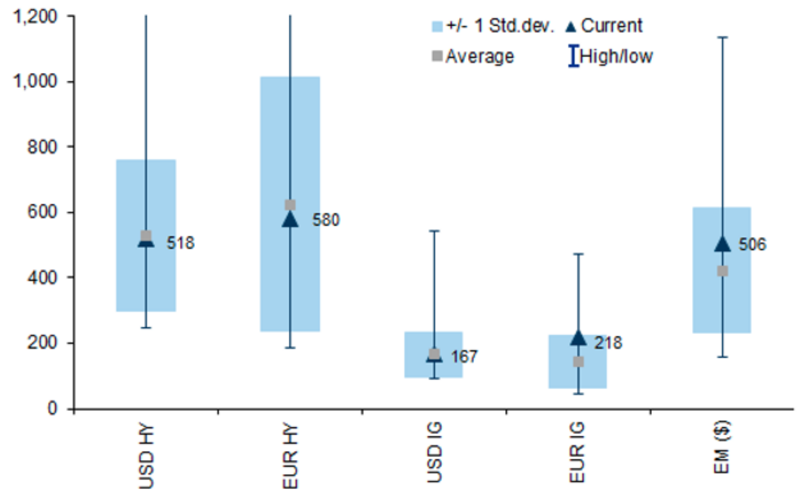
2. Bond Markets Also Finish a Tough First Half

The fixed income markets have not been immune to the weak financial markets this year with the aggregate bond index off over 11% year-to-date.

Source: Morningstar

Given the rapid rise in interest rates, declines have been experienced for all durations, although as expected in a rising rate environment, the longer duration exposure has resulted in larger declines. Another component of the decline in bonds has been a rise in credit spreads. Credit spreads in the U.S. have expanded to historical levels from historic lows, and credit spreads in the rest of the world are now above historical averages.

Credit spreads (US HY and IG since 1985, EUR IG since 1997, EUR HY and EM since 1998)



Source: Haver Analytics, iBoxx, Goldman Sachs Global Investment Research

As the market adjusts to a potential recessionary scenario, credit spreads are seen as having further risk to widening, but this may be offset by a cap to the recent increase or even cuts in the benchmark government yields.

In any event, while there may be further pressure on bonds as the Federal Reserve continues to be committed to a tightening monetary policy, current bond yields have become much more attractive and provide a degree of income to offset the uncertain environment.

Thinking Ahead

The financial markets ended June on a sour note capping off the worst first half of a year in five decades. July will kick off a new half of the year as well as a closely watched round of corporate outlooks which will set the tone for the rest of the year. While past performance is not a guarantee of future performance, similar past bear markets have provided oppotunities for a material recovery in stock prices.

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

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