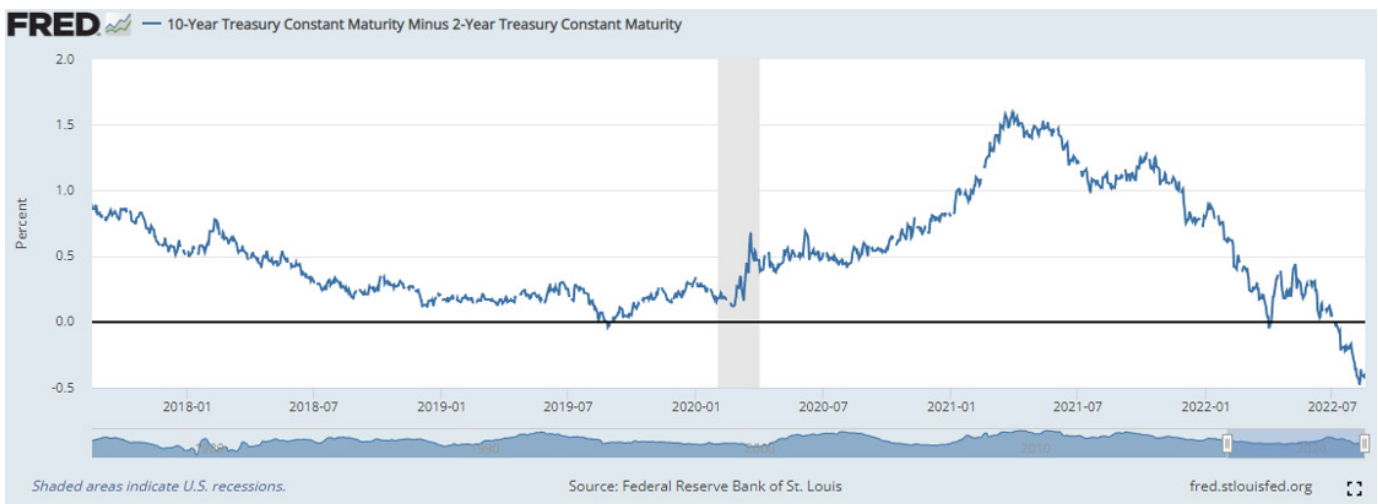


WEEK IN REVIEW

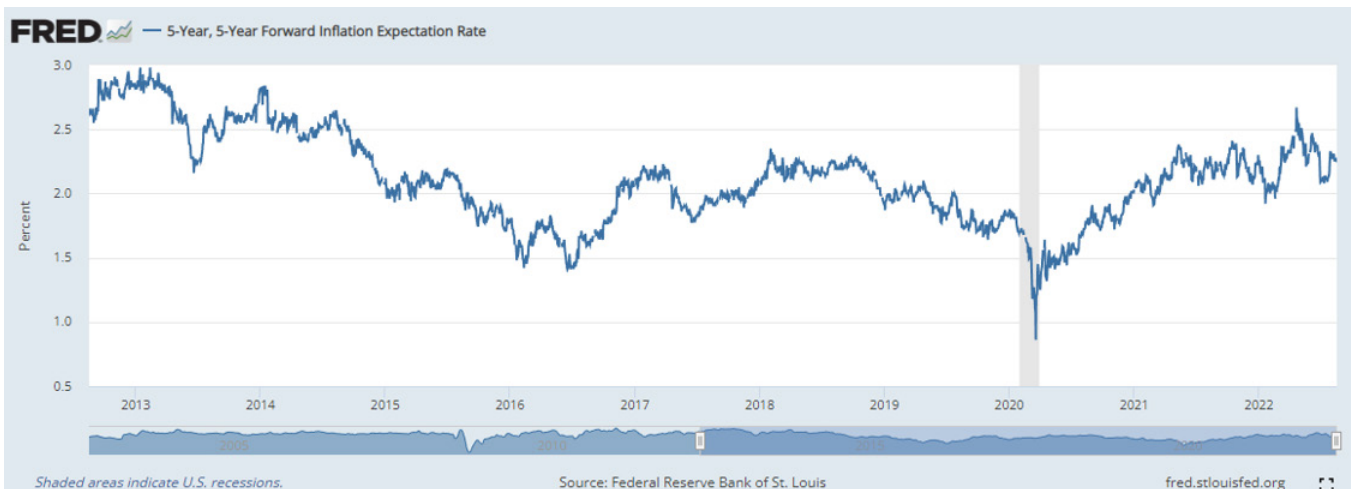
FRIDAY, AUGUST 19TH, 2022

1. A HISTORIC YIELD CURVE INVERSION HAS A SILVER LINING

Currently, the 2-year and 10-year treasuries have inverted to their deepest levels in over 20 years. The inversion of the yield curve is often seen as an indicator of a future recession, as an inversion is seen as being correlated with restrictive policy leading to a slowdown in the economy.



Driving the current inversion is the Federal Reserve's tightening policy directly impacting (raising the yield) shorter-term duration bonds such as the 2-year treasury. Conversely, the primary driver of yields of longer-duration bonds like the 10-year treasury is the expectation for longer-term inflation. Longer-term treasury yields are a combination of the inflation rate and the real yield, both of which include a risk premium to compensate the investor for the term of the investment. 10-year treasuries currently yield 2.89% of which the implied inflation rate is 2.44% and the implied real yield is 45 bps. The proxy for inflation, in this case, is the 5y5y forward rate published by the Federal Reserve which represents where the market is attributing inflation will average over the five-year period from today.



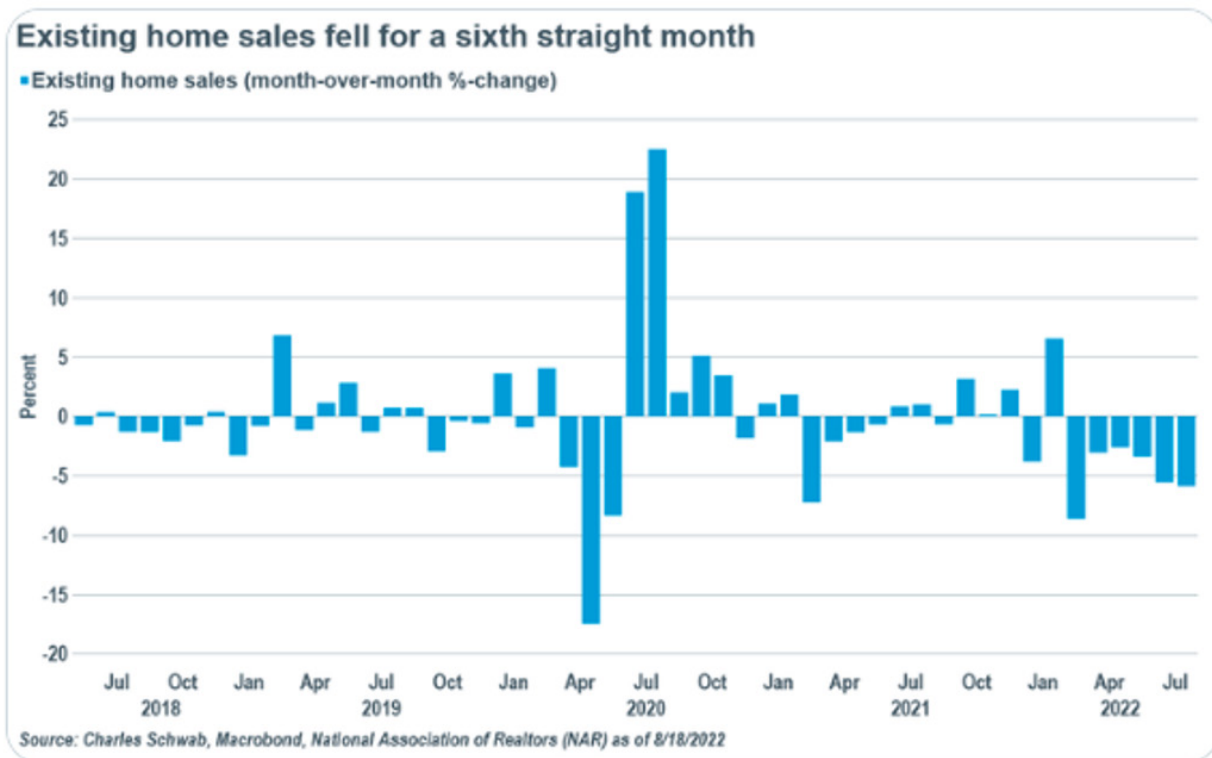
Perhaps surprisingly, given the high level of current inflation, the 5y5y rate is trending towards pre-Covid levels.

For the expectation for lower inflation to be achieved, it is likely that the economy will have to slow to moderate employment and spending. However, improving supply chains, higher inventories, and easier year-over-year comps will also be important contributors. As the economy slows, higher volatility in the financial markets should be expected (as we have seen), but periods of past slowdowns and even recessions have tended to be short and followed by robust recoveries.

So while the historic inversion of the yield curve may be unsettling and indicative of a future recession, the moderation of inflation expectations driving longer-term treasury yields can also be seen as a very positive development for long-term investors.

2. HOME SALES SLOW AS RATES RISE BUT PRICES REMAIN FIRM ON LIMITED SUPPLY

U.S. existing home sales fell to a fresh two-year low in July and the sixth straight monthly decline, further evidence that the Federal Reserve’s aggressive monetary policy tightening campaign was dampening demand for housing, although home price levels remain high. On a year-over-year basis, existing home sales were down 20.2%.



The report came on the heels of data this week showing single-family housing starts, which account for the biggest share of homebuilding, tumbled to a two-year low in July. The National Association of Home Builders/Wells Fargo Housing Market sentiment index fell below the break-even level of 50 in August for the first time since May 2020.

The rationale for the decline has been rising mortgage rates and negative consumer sentiment. 30-year fixed mortgage rates have pulled back to 5.65% from the recent peak of 6.11% but are well above 3.22% at the start of the year. The relatively high mortgage rate is expected to remain an overhang on the housing market for the rest of the year. Slowing demand could help to slow house price inflation, though much would depend on supply, which remains low. The median existing house price rose 10.8% from a year earlier to \$403,800 in July. That was the smallest gain in two years.

In terms of supply, there were 1.310 million previously owned homes on the market, unchanged from a year ago. At July's sales pace, it would take 3.3 months to exhaust the current inventory of existing homes, up from 2.6 months a year ago. A six-to-seven-month supply is viewed as a healthy balance between supply and demand. Given the supply and demand metrics even at the lower sales levels, there is a low expectation for a significant pullback in housing prices.

THINKING AHEAD

Fears of a Fed-induced recession are elevated on the back of restrictive monetary policy and illustrated in a historic inversion of the yield curve. However, the inversion also represents the concerted effort by the Fed to lower inflation with a policy to drive-up short-term rates to get longer-term inflation back towards pre-Covid levels. This goal is overall positive for longer-term financial market stability and valuation, although the threat of slower growth or recession introduces risk to corporate earnings and credit. For longer-term investors, a short-term lower growth but longer-term lower inflation outcome will likely prove to be an acceptable trade-off.

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

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