PALLAS
CAPITAL ADVISORS

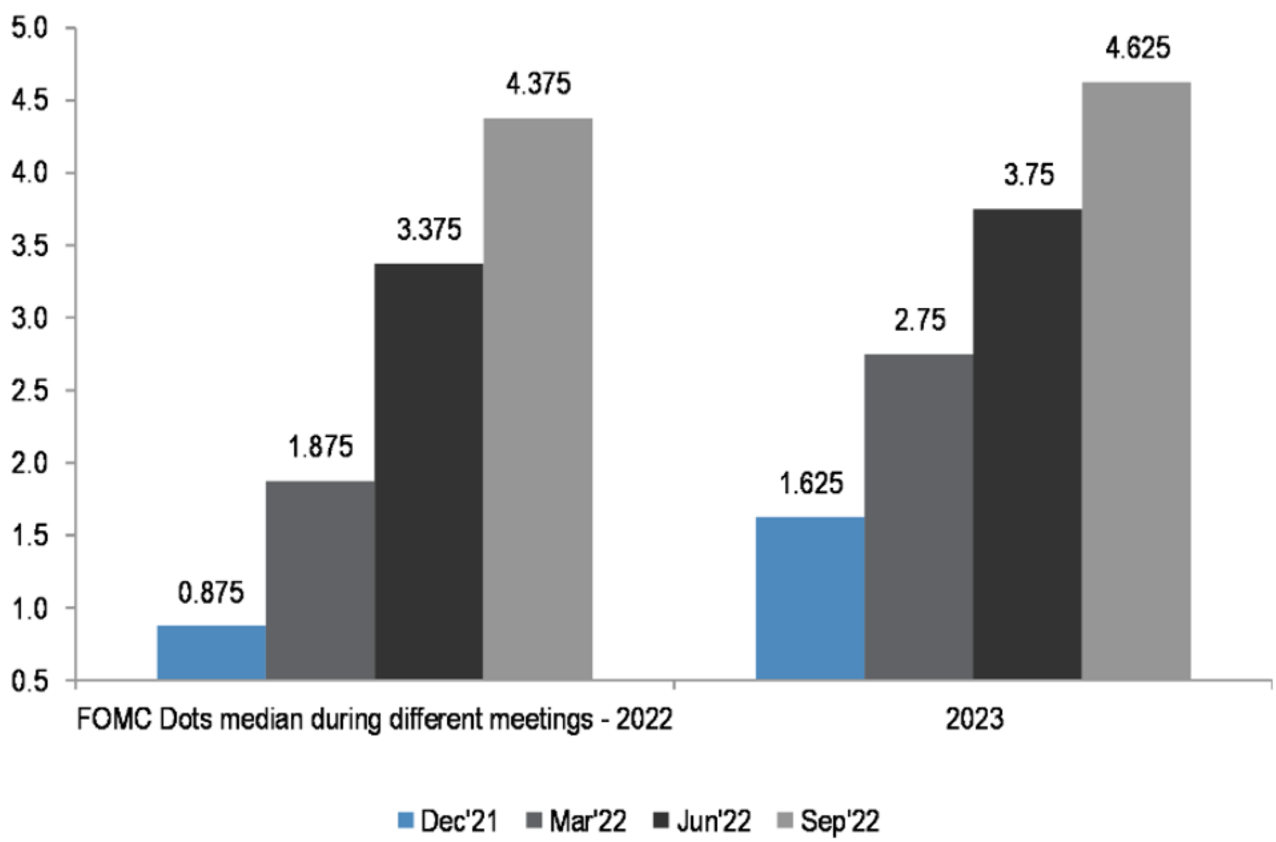
Week in Review

Friday, September 30th, 2022

1. September continues its tradition as a difficult month for markets on surging rate expectations

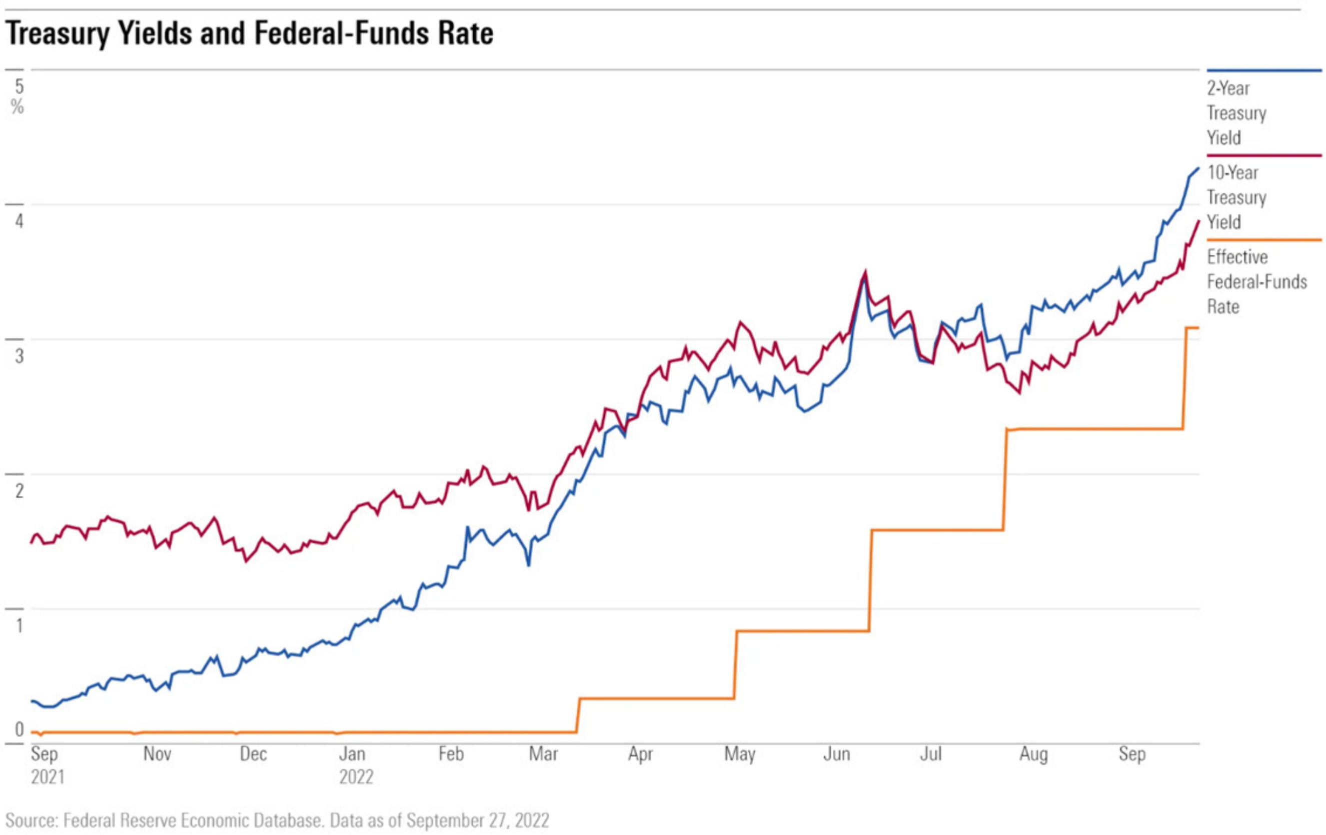
Last week we discussed the Federal Reserve policy update in terms of the latest 75 basis point increase and the implied Fed Funds rate target based on the Dot projections by its members. The Dot projection peak rate, based on the Fed's 09/21/2022 meeting, moved to 4.6%. The dramatic change in expectations is hard to overstate and is the primary factor driving both the equity and bond markets lower in September and year-to-date.

Fed Funds Peak Rate Expectation



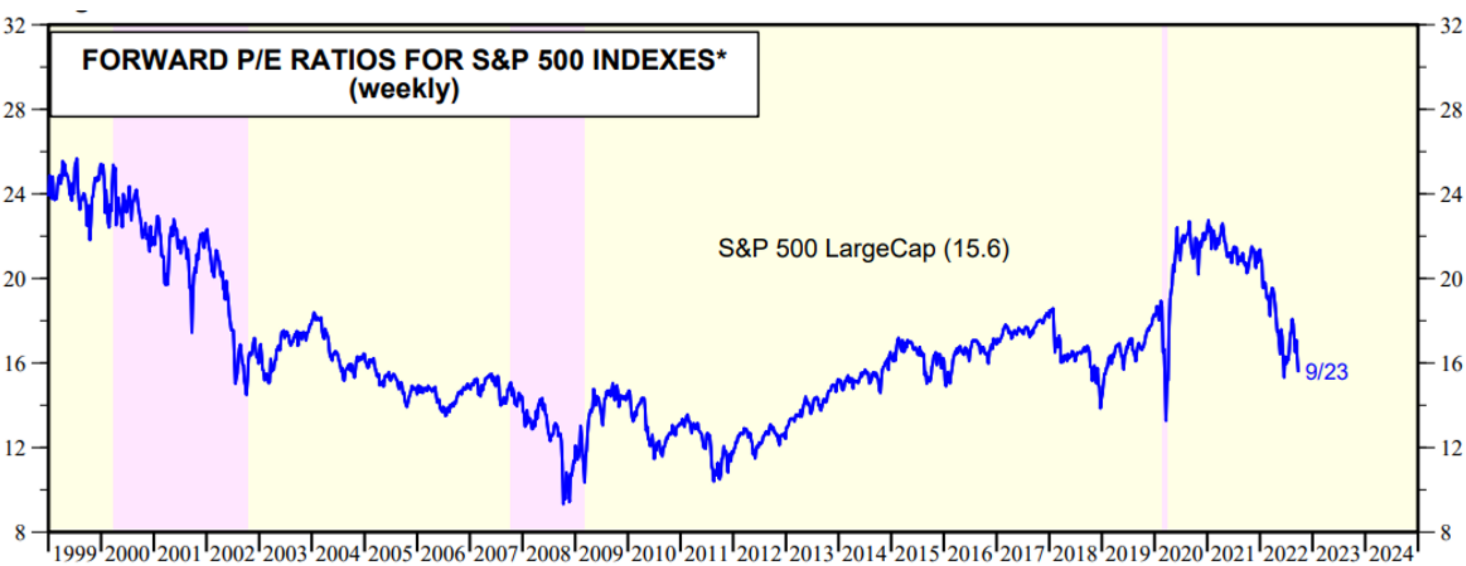
Source: Bloomberg Finance L.P.

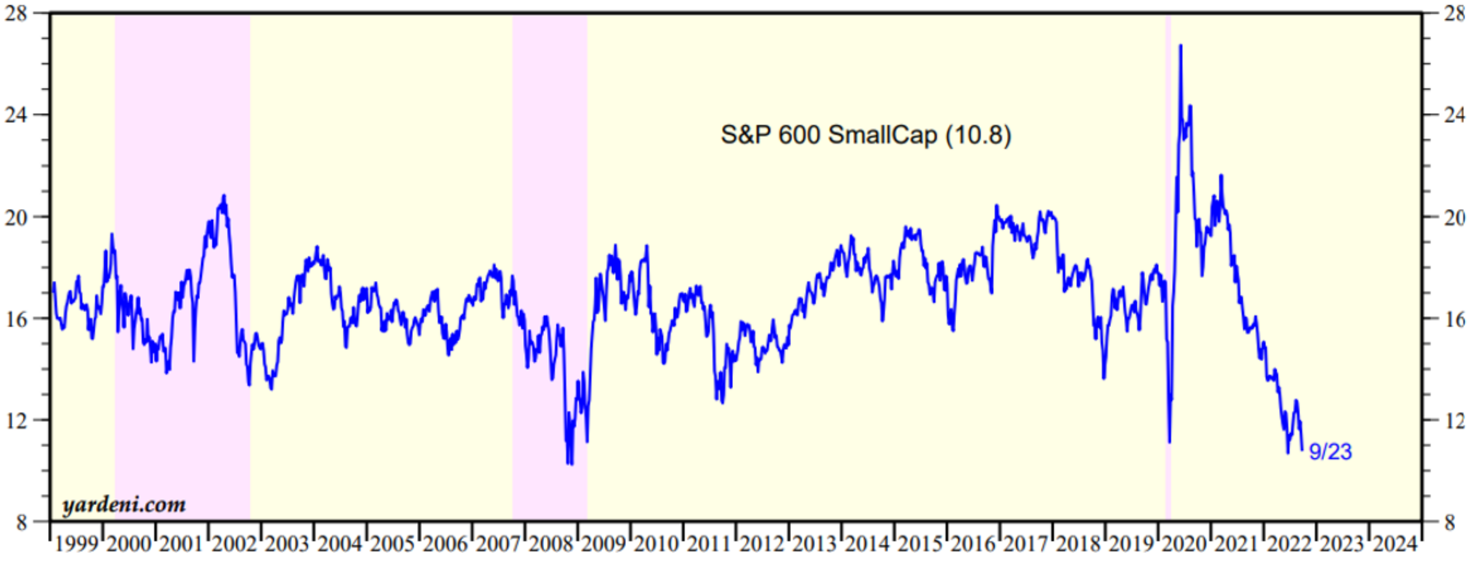
The rapid pace of increases and a higher expected end point for the Federal funds rate has been the driver of higher bond yields. Bond yields soared to their highest point in years this week with the two-year Treasury reaching 4.16% and the 10-year Treasury topping 4%.



Source: Morningstar

As yields rise, the pressure on prices for both bonds and equities has been downward. For U.S. large-cap stocks, the price-to-earnings ratio (P/E) has pulled back over 25% in 2022 and small-cap stocks now trade near the lowest P/E ratio in over 20 years.

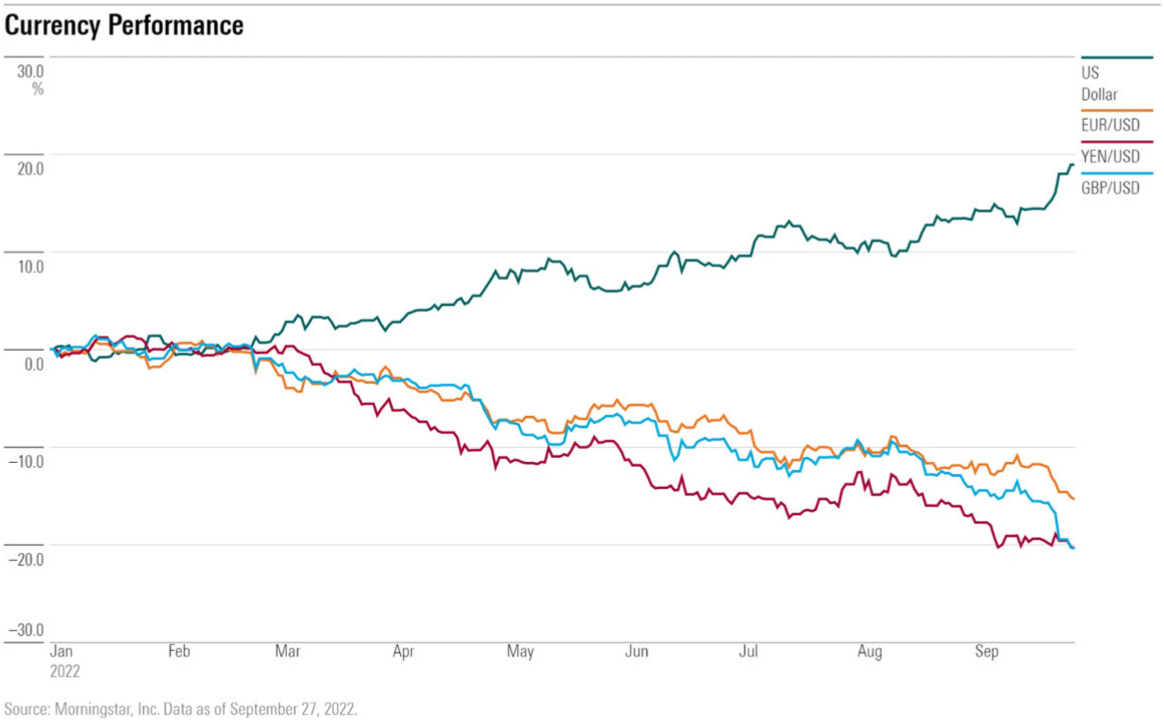




Source: Yardeni Research

For equities, an additional factor is in play with earnings expectations. On a year-to-date basis, while Fed fund rate expectations have surged higher, earnings expectations have so far been relatively stable.

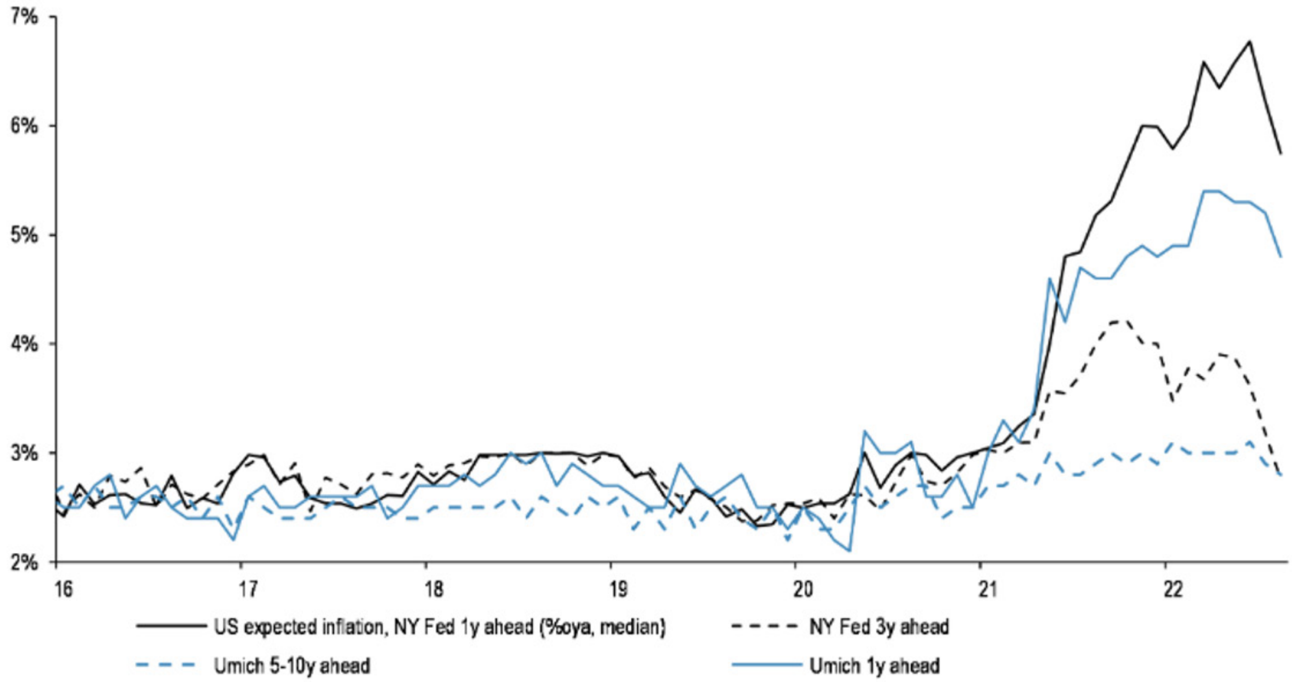
However, there is reasonable skepticism about the ability of earnings projections to be maintained, given substantial downward pressures. In mid-September, FedEx lowered its earnings expectations citing negative macroeconomic trends, particularly in Asia and Europe, leading to a decline in volumes. Shortly thereafter, Ford lowered near-term expectations citing ongoing supply chain and material cost pressures. Finally, this week, Apple lowered the upper end of its projected cell phone deliveries. Even to the degree these issues may be somewhat company specific, the surging strength of the dollar is likely to pressure corporate earnings for the large multinational U.S. companies.



The potential for lower prospective earnings is likely to weigh on the market until proved otherwise and compounds the impact of higher-than-anticipated interest rates.

While financial markets are in the midst of a storm, seeds for an eventual improvement are also being planted. The nature of the seeds is lower inflation that may at least cap the trajectory of Fed rate hikes. Looking at expected inflation surveys, one-year, three-year, and longer-term inflation expectations have all appeared to peak and are trending down.

U.S. Expected Inflation Surveys



Source: UMich, FRBNY, J.P. Morgan Economics Research

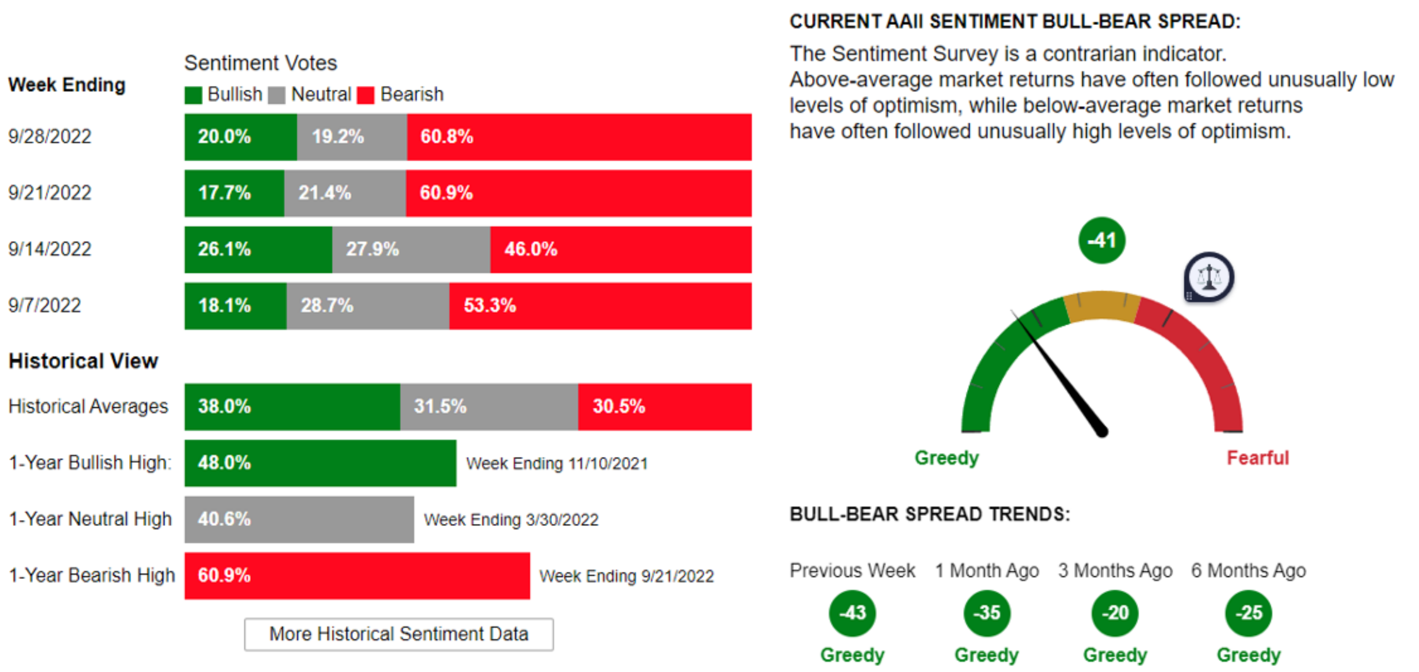
Reasons for peaking inflation include lower energy prices, rising inventory levels, lower corporate expectations for price increases, declining rent indices, and declining excess job openings. The growing probability of a recession might accelerate these trends and more. Another important factor is easier comps going forward as inflationary forces prompted by excess demand versus supply coming out of Covid and the energy spike, exacerbated by the Ukraine War, will be lapped and dropout of the annual pace calculations looking forward into 2023.

For the time being, it is generally accepted that the Fed is pursuing the correct battle to reduce inflation, and the course of hawkish policy is expected to succeed in that regard. Ultimately, lower inflation should lead to a clear peak and then reduction over time in interest rates. This would be a clear positive catalyst for bonds which are close, or at least much closer than even several months ago, to pricing in the present expectation for peak rates. For equities, negative earnings revisions remain a key concern with cyclical stocks such as consumer discretionary, industrial, and materials stocks seen at heightened risk. However, lower multiples for the equity market are undoubtedly factoring in at least some of this risk.

2. September financial market performance and sentiment fall from already low levels

At the beginning of September, we highlighted the AAII Sentiment Survey as being particularly negative. September has seasonally been among the worst months for financial markets and 2022 has continued to add fuel to the trend. So, as we end September, the AAII index is finishing the month even more bearish than it started.

AAII Investor Sentiment Survey



The sentiment survey is a contrarian indicator of forward performance. With the latest bearish sentiment trends, the survey indicates a high level of opportunity or "greed". Of course, as discussed above, there are many drivers for the weakness being experienced. Top of the list are higher rates, earnings risk, and recession.

Past performance is no guarantee of the future, but historically, the S&P 500 index has gone on to realize above-average and above-median returns during the six- and 12-month periods following unusually high bearish sentiment readings. As September has followed the historical trend of being a challenging month for financial markets, perhaps the more optimistic historical trend for high bearish sentiment can also prevail when given time.

Thinking Ahead

As we finish off the dreaded month of September, financial markets are putting in their worst performance since the March 2020 sell-off at the onset of Covid.   Equity multiples and bond yields finish the month at 20-year low valuation levels. The causes are clear with a Federal Reserve intent on fighting inflation, the correct course of action, and earnings and credit risks rising. While the financial market storm seems to have hit with force and resolve, the ingredients for it to diminish are also in place.

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