# PCA Quarterly Commentary

**Q3 2022**

## Third Quarter Financial Market Summary

Financial markets were very volatile in the third quarter of 2022 and ultimately ended weaker across the board following a drawdown in September. The drop in markets occurred following stubbornly high inflation data and particularly hawkish comments by the Federal Reserve that further tightening policy was deemed necessary.

As with the first two quarters of 2022, the rising rate environment has seen strong correlation between equity and fixed income markets leaving little room to hide besides cash surrogates.

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 |
|---|---|---|---|---|---|---|
| Q3 2022 | -4.9% | -2.1% | -9.2% | -11.6% | -4.7% | -1.7% |
| YTD 2022 | -23.9% | -25.1% | -26.2% | -27.2% | -14.4% | -15.2% |

Source: Orion

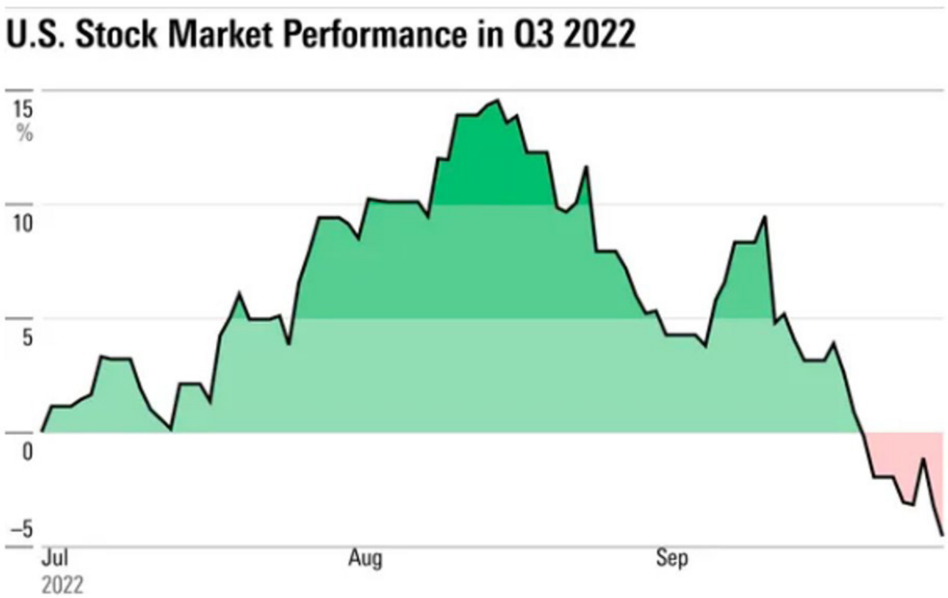
| Annual Returns | | | Monthly Returns | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2019 | 2020 | 2021 | Jan 2022 | Feb 2022 | Mar 2022 | Apr 2022 | May 2022 | Jun 2022 | Jul 2022 | Aug 2022 | Sep 2022 | YTD 2022 |
| Large Cap Equity 31.49% | Small Cap Equity 19.96% | Large 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% | Small Cap Equity 10.44% | Emerging Market Equity 0.42% | High Yield -3.97% | U.S. Fixed Income -14.61% |
| 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% | Large Cap Equity 9.22% | Small Cap Equity -2.05% | U.S. Fixed Income -4.32% | High Yield -14.74% |
| 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% | Real Estate 7.96% | High Yield -2.30% | Global ex-U.S. Fixed Income -5.87% | Large Cap Equity -23.87% |
| 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% | High Yield 5.90% | U.S. Fixed Income -2.83% | Large Cap Equity -9.21% | Global ex-U.S. Fixed Income -23.88% |
| 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 4.97% | Large Cap Equity -4.08% | Dev ex-U.S. Equity -9.26% | Small Cap Equity -25.10% |
| 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% | U.S. Fixed Income 2.44% | Dev ex-U.S. Equity -4.67% | Small Cap Equity -9.58% | Dev ex-U.S. Equity -26.23% |
| 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% | Global ex-U.S. Fixed Income 1.92% | Global ex-U.S. Fixed Income -4.99% | Emerging Market Equity -11.72% | Emerging Market Equity -27.16% |
| 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% | Emerging Market Equity -0.25% | Real Estate -6.49% | Real Estate -12.42% | Real Estate -29.90% |

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

Past performance is not a guarantee of future performance. It is not possible to invest directly into an index.

The S&P 500 finished the third quarter firmly in correction territory being down 23.9% for the year. Other parts of the market have seen an even worse performance with the small-cap benchmark Russell 2000 Index down 25.1%. The technology-heavy NASDAQ Composite has fallen 31.9%. Global markets have also been weak with the MSCI Core Developed down 26.2% and MSCI Emerging markets down 27.2%. Public REITs have been particularly hard hit, down nearly 30% year to date, which is in line and reflective of their correlation with long-term treasuries.



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

Weakness was not confined to equity markets with the U.S. Aggregate Bond Index contracting -14.4%, its worst performance since its inception in 1973, and the high yield bond index down -15.2%. As we have discussed previously, 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 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.

For equity markets, volatility was notable during the third quarter. Markets saw a strong rally off the previous low mark for the year in mid-June, accelerating to the upside on perceived peak inflation and belief that the Fed would moderate the pace of rate increases. The optimism was summarily crushed commencing in August on disappointing inflation data and heightened hawkish commentary.

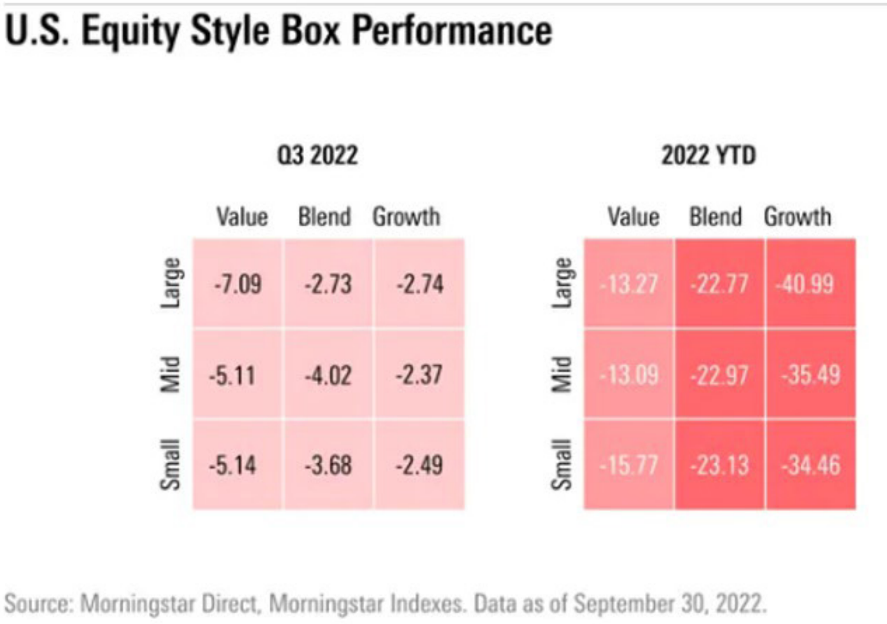
In terms of sector performance within equities, energy remained a standout but by lesser margin as commodity prices have fallen from the highs realized in the aftermath of Russia's invasion of Ukraine. The consumer cyclical sector also showed a positive return in aggregate for the third quarter but excluding Tesla, which comprises 40% of the sector weighting, the sector was down 4.6%. For the year-to-date, the consumer sector is down 31.0%, trailing the market.

U.S. Equity Sector Performance

| | Performance % | | |
|---|---|---|---|
| **Cyclical** | Q3 2022 | Q2 2022 | 2022 YTD |
| Basic Materials | -6.16 | -17.53 | -23.61 |
| Consumer Cyclical | 3.21 | -25.19 | -31.02 |
| Financial Services | -3.24 | -17.13 | -22.22 |
| Real Estate | -10.71 | -15.01 | -28.84 |
| **Sensitive** | | | |
| Communication Services | -12.72 | -21.89 | -40.14 |
| Energy | 3.13 | -5.96 | 34.29 |
| Industrials | -3.49 | -15.24 | -21.33 |
| Technology | -6.12 | -22.33 | -34.13 |
| **Defensive** | | | |
| Consumer Defensive | -6.39 | -5.70 | -12.88 |
| Healthcare | -4.94 | -7.07 | -15.22 |
| Utilities | -5.87 | -5.07 | -6.64 |

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

Of note for the quarter was the loss of relative leadership by defensive sectors. Consumer defensive, utilities, and higher dividend payors such as REITs underperformed the market for the quarter. The change in leadership during the quarter can also be observed in the characterization of equities according to growth versus value. In the first two quarters of the year, growth stocks substantially underperformed value stocks and still trail on a year-to-date basis. Going into 2022, growth stocks had heightened exposure for multiple compression as well as a collapse in speculative, non-earners that were generally categorized as growth stocks. The reduced differential in relative performance suggests greater balance may have been put in place across sector and style for equities.



U.S. Equity Style Box Performance

Q3 2022

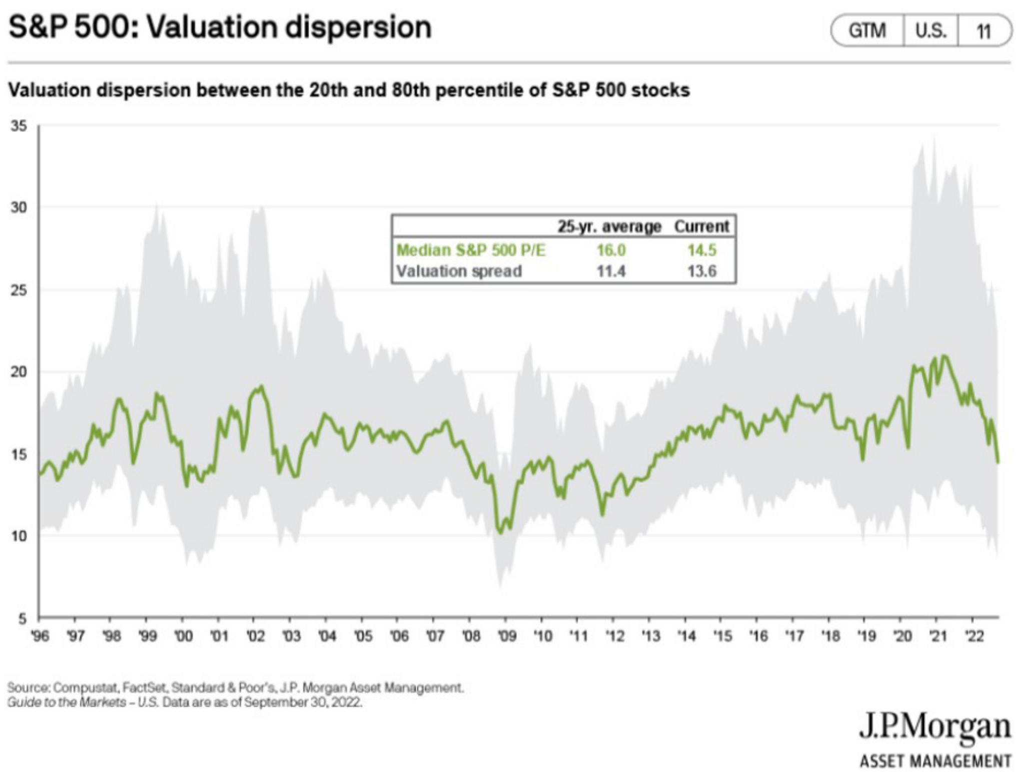
| | Value | Blend | Growth |
|---|---|---|---|
| Large | -7.09 | -2.73 | -2.74 |
| Mid | -5.11 | -4.02 | -2.37 |
| Small | -5.14 | -3.68 | -2.49 |

2022 YTD

| | Value | Blend | Growth |
|---|---|---|---|
| Large | -13.27 | -22.77 | -40.99 |
| Mid | -13.09 | -22.97 | -35.49 |
| Small | -15.77 | -23.13 | -34.46 |

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

Supporting the perspective that sector and style may have reached a level of balance is valuation dispersion for the S&P 500. As valuation multiples have corrected downward this year, the dispersion of valuation multiples across the S&P 500 has also contracted from record levels. While valuation dispersion is still above the long-term historical average, reduction in valuation dispersion has correlated historically with a more favorable environment for prospective equity returns.




International equities realized further relative underperformance in the third quarter versus U.S. equities. At a top level, the relative underperformance has been driven by the strength of the dollar which has depressed the value of international stocks when translated into U.S. dollar performance. Secondarily, geopolitical disruption and higher energy prices are having a greater impact on the fundamental backdrop in international markets. Looking at valuations, the macro backdrop is likely reflected in valuations with price-to-earnings (P/E) and dividend yields for international markets versus U.S. markets at historic relative differentials.


Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
*Guide to the Markets – U.S.* Data are as of September 30, 2022.

J.P.Morgan
ASSET MANAGEMENT

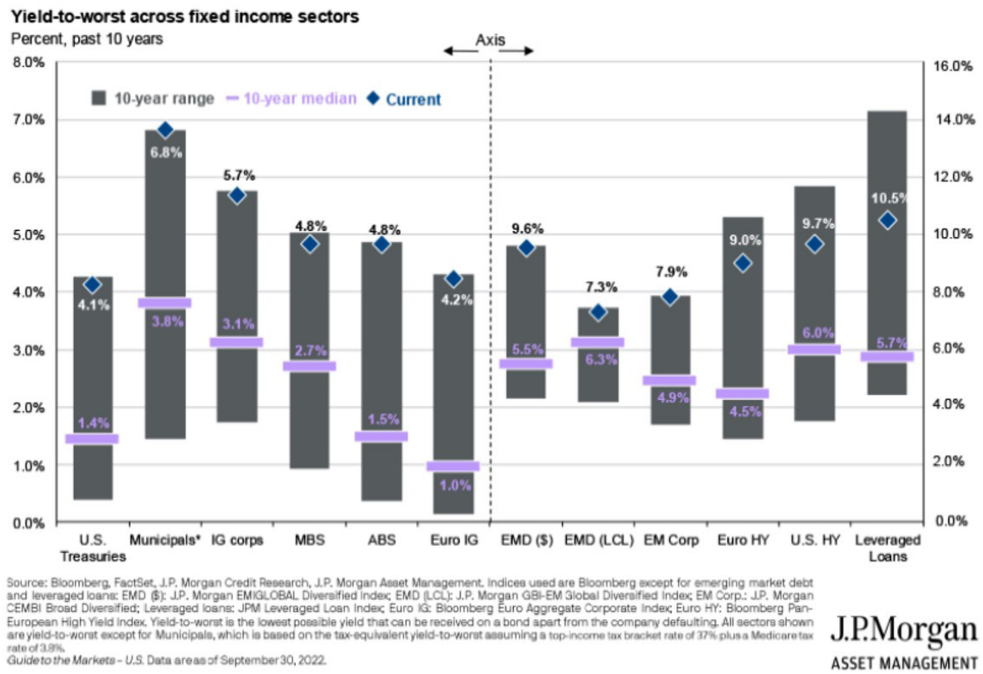
Falling in response to the rising rate environment, the bond market did not prove a safe haven relative to equities. Bonds are now tracking to the worst period of performance in decades. Long-term bonds have been hit the hardest, but even short-term bonds have realized negative returns.

## Morningstar Bond Indexes

| | Performance % | | |
|---|---|---|---|
| **Core Bond** | **Q3 2022** | **Q2 2022** | **2022 YTD** |
| Core Bond | -4.83 | -4.50 | -14.57 |
| **Sector** | | | |
| U.S. Treasuries | -4.53 | -3.65 | -13.07 |
| Corporate | -5.20 | -6.94 | -18.73 |
| High Yield | -0.68 | -9.90 | -14.57 |
| Mortgage | -5.38 | -3.96 | -13.70 |
| **Maturity** | | | |
| Short-Term Core | -2.22 | -1.16 | -6.85 |
| Intermediate Core | -5.23 | -4.24 | -14.68 |
| Long-Term Core | -9.54 | -12.12 | -29.45 |
| **Inflation-Protected** | | | |
| TIPS | -5.55 | -6.25 | -13.61 |
| **Emerging Market** | | | |
| Composite | -3.94 | -8.81 | -20.60 |
| Sovereign | -4.06 | -11.38 | -22.01 |
| Corporate | -3.84 | -6.93 | -19.57 |

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

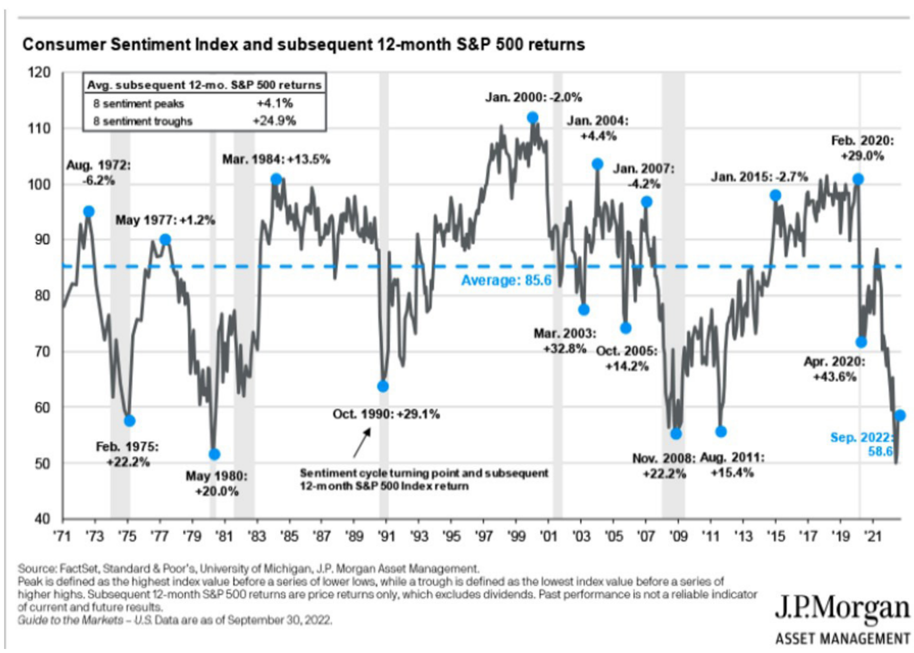
On the flip side, bond yields are now at or near 10-year highs.  For shorter-duration bonds, the yields on bonds are now an attractive diversifier for income in a portfolio as bond yields are now well above the average dividend for equities.  Longer duration bonds may now be attractive and have the potential for appreciation as they yield above long-term inflation expectations.




In conclusion, the third quarter has solidified that the financial markets are in a powerful bear market.  On the positive side, the key driver of this bear market is inflation, and the policy response by central banks around the world are attempting to bring inflation down. Unfortunately, bringing inflation down is a painful process for financial markets.

## First Days of October Start on a Positive Note

As we turn the calendar from September to October, at least a temporary relief from the financial market downdraft in September has occurred.  While a few days is too short a period to determine whether a bottom has been put in place in markets, the change in trend should at least strike a moment to reflect on why such a change may occur and whether such a change is sustainable.




In favor of the short-term argument is extreme negative sentiment and the potential that the market was oversold. The cornerstone for this argument is that public financial markets are subject to capital flows, and negative capital flows, as was seen in September, can produce undue pressure on pricing. Supportive of this argument is the breadth of stocks trading at 52-week lows and the contagion across all sectors. Supportive of this argument is the negative sentiment which has reached a nadir consistent with historical periods of financial market lows.

The other and more sustainable view for a market reversal is the belief that the investment environment will see improvement. The drivers for this argument are better-than-expected company fundamentals and waning pressure on key valuation metrics. While a change in perspective of company fundamentals has unlikely taken place this week, earnings season will commence in force in the next two weeks. On a positive note, an acceleration of negative preannouncements has not occurred.

The more immediate driver for a sustainable reversal in October of financial markets is the waning of inflation and the upward pressure on rates. Financial markets hang on every data release. On the positive side, this week saw a drop in open but unfilled jobs. On the more cautious side, job growth data for September showed continued strength and upward revisions for prior months.

Short-term market volatility is likely to continue as the foundation for better long-term performance is put in place. In any case, September was a difficult month for financial markets and the bounce in early October was a nice reprieve.

## Thinking Ahead

A deeper dive analysis of the third quarter financial performance reveals that the repercussions of high inflation and rising interest rates have rippled through all aspects of the financial markets. For the equity markets, positioning based on often used metrics such as growth versus value and defensive versus cyclical did not prove a significant differentiator for relative performance. As valuation metrics and dispersion have converged, we believe the differentiating factor for performance will be driven by fundamentals.

For fixed income, we believe the overriding driver will be inflation and expectations for peak funds rates. Attractive yields can now be found within the asset class with potential for capital appreciation as well with a longer-term view as inflation should eventually moderate from the current elevated levels without taking on undue credit risk.

October has already shown that markets can move sharply upwards in a short period of time, although we believe volatility will likely prevail as the foundation for long-term appreciation – positive fundamentals and lower inflation – remains a work in progress.

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

Sincerely,

**Mark A. Bogar, CFA®, CAIA®**
Chief Investment Officer
Pallas Capital Advisors

**Stephen Kylander**
Senior Portfolio Manager
Pallas Capital Advisors

Large Cap Equity (S&P 500) measures the performance of large capitalization U.S. stocks. The S&P 500 is a market-valueweighted index of 500 stocks. The weightings make each company's influence on the Index performance directly proportional to that company's market value.

Small Cap Equity (Russell 2000) measures the performance of small capitalization U.S. stocks. The Russell 2000 is a market-value-weighted index of the 2,000 smallest stocks in the broad-market Russell 3000 Index.

Developed ex-U.S. Equity (MSCI World ex USA) is an index that is designed to measure the performance of large and mid cap equities in developed markets in Europe, the Middle East, the Pacific region, and Canada.

Emerging Market Equity (MSCI Emerging Markets) is an index that is designed to measure the performance of equity markets in 25 emerging countries around the world.

U.S. Fixed Income (Bloomberg US Aggregate Bond Index) includes U.S. government, corporate, and mortgage-backed securities with maturities of at least one year.

High Yield (Bloomberg High Yield Bond Index) measures the market of USD-denominated, non-investment grade, fixedrate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.

Global ex-U.S. Fixed Income (Bloomberg Global Aggregate ex US Bond Index) is an unmanaged index that is comprised of several other Bloomberg indices that measure the fixed income performance of regions around the world, excluding the U.S.

Real Estate (FTSE EPRA Nareit Developed REIT Index) is designed to measure the stock performance of companies engaged in specific real estate activities in the North American, European, and Asian real estate markets.

Cash Equivalent (90-day T-bill) is a short-term debt obligation backed by the Treasury Department of the U.S. government.