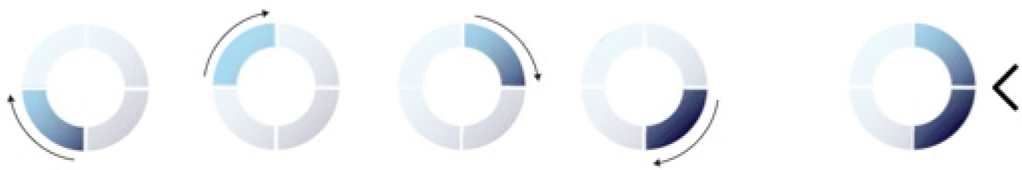
Pallas Perspective

December 1, 2023

Economic Indicators Point to a Downturn, Yet a Goldilocks Outlook Sparks Excitement

In assessing current risks and opportunities in the U.S. financial markets, having an understanding of the current position and anticipated direction of the economy in the coming year can establish a foundation for tactical positioning and risk assessment. While inherently subjective, the following table suggests that the U.S. is currently in a late cycle and is trending towards a downturn.

U.S. Economic Indicator Variables



	REPAIR	RECOVERY	EXPANSION /LATE CYCLE	DOWNTURN	WHAT WE ARE SEEING NOW
ECONOMIC GROWTH	Weak, Improving	Moderate, Improving	Strong, Plateauing	Weak, Deteriorating	Plateauing
CREDIT GROWTH	Weak	Accelerating	High	Falling	Falling
CENTRAL BANK POLICY	Easy	Starting to Tighten	Tightening	Easing	Tightening
INFLATION PRESSURE	Low, Stabilizing	Moderate, Rising	High, Rising	Moderate, Falling	Moderate, Falling
YIELD CURVE	Steep	Flattening	Flat/Inverted	Steepening	Flat/Inverted
ASSET VALUATIONS	Below Average, Rising	Near Average, Rising	Above Average, Rising	Falling to Below Average	Above Average, Rising
FUNDAMENTALS	Profits Down, Leverage Down	Profits Up, Leverage Down	Profits Up, Leverage Down	Profits Down, Leverage Up	Profits Down, Leverage Up
CREDIT vs. EQUITY	Credit Preferred	Credit & Equity Both Up	Equity Preferred	Credit & Equity Both Down	Equity Preferred
VOLATILITY	Above Average, Rising	Above Average, Falling	Below Average, Stable	Below Average, Rising	Below Average, Stable

Source: Loomis Sayles

On the positive side, the direction of the cycle suggests further abatement of inflation, setting the stage for prospective easing policies (lower interest rates). This shift would be a welcome departure from the past 18 months and could support financial market valuations. However, the next stage of the cycle also aligns with deteriorating economic growth, declining corporate profits and earnings, and a fall in credit—historically factors that have weighed on financial market performance.

At this juncture, financial markets seem to be navigating a positive balance between offsetting forces, operating under the assumption of a 'soft landing.' In such a scenario, markets anticipate the Federal Reserve (Fed) to maintain its position, inflation to decelerate, and lower bond yields to provide organic support to the economy. Economic growth would decelerate, but not contract, while healthy risk appetites persist. In other words, a 'Goldilocks' outlook for financial markets is anticipated, offering opportunities for both equities and fixed income. This outlook gained swift acceptance in November, marked by strong performance for financial assets during the month.

In a potential 'hard-landing' scenario, we anticipate a surge in unemployment, a decline in consumer spending, and weakened demand for corporates. This, coupled with disinflation leading to a profit recession from falling prices, may unfold. On a positive note, concerns about inflation would dissipate, creating room for the Fed to implement easing policies.

In this envisaged scenario, high-quality fixed income is positioned for strong performance, while lower credit may face pressure due to rising spreads and default concerns. Equities, particularly cyclicals, could experience collective pressure. Conversely, quality growth and defensive equities are expected to weather an economic downturn more resiliently.Looking ahead, the positive outcome of a downturn lies in the resetting of inflation and prospective growth from a cyclical trough, laying the foundation for the next economic growth cycle.

At Pallas Capital Advisors, we strive to remain on top of the macro investment environment while retaining a longer-term perspective in allocating across asset classes and individual investments. We believe that throughout investment cycles, a balanced portfolio focused on strong fundamentals and quality, combined with reasonable valuations reflecting achievable medium-term expectations, should provide attractive risk-adjusted returns that align with our clients' financial objectives. Heading into 2024, we perceive opportunities for tactical investment calls driven by the ever-evolving economic landscape, yet we remain grounded in our strategic asset allocation and selection.