PALLAS
CAPITAL ADVISORS

Pallas Capital Quarterly Commentary

Q2 2024

Investment Markets Continue Gains in 2024 but Narrowness of Returns Accelerates

Following a strong first quarter marked by reduced expectations for rate cuts by the Federal Reserve, investors went into the second quarter apprehensive about the inflation forecast. A series of hotter-than-expected inflation readings in April sent stocks and bonds lower, but the weight on markets began to lift in May as the outlook for inflation expectations started to look more favorable. By the end of June, the Russell 1000 index rose by 3.57% for the second quarter, up 14.23% year-to-date and 23.87% over one-year. Mega cap technology stocks continued to drive market gains, with Nvidia (NVDA) alone contributing nearly 40% percent of the market's overall return for the quarter. The highly anticipated spread of the market rally into other sectors did not materialize as value stocks underperformed larger growth stocks, and small-cap stocks saw negative returns.

Bond markets closed the quarter in positive territory, as investors gained confidence that inflation was improving. That lowered yields and added some price appreciation back to bondholders' portfolios. The core U.S. aggregate index was up 0.13% for the second quarter though it remains down -0.75% for the year-to-date due to diminished expectations for rate cuts since the beginning of the year.

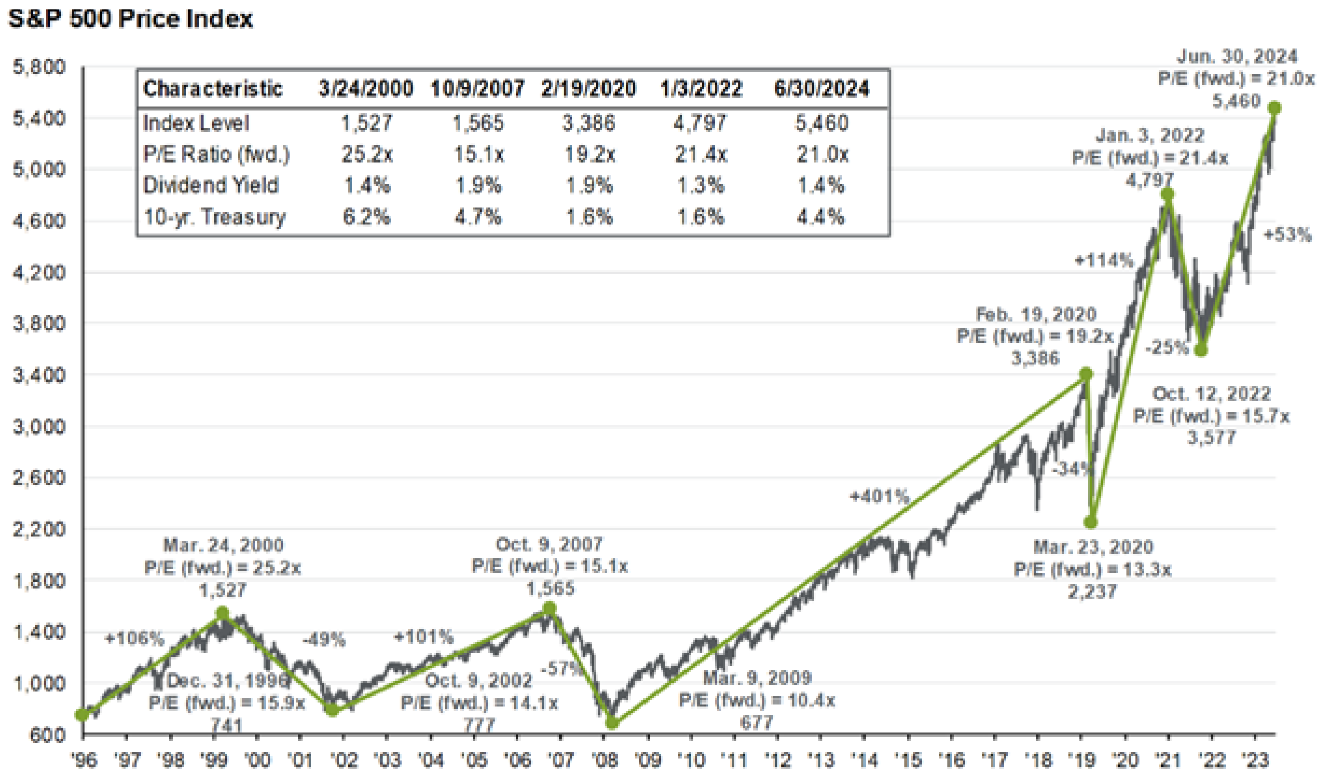
International equity markets all logged gains for the second quarter but trail behind U.S. markets on a year-to-date basis. In local currency terms, U.S. markets gained 11.0%, and when adjusted for U.S. currency, they gained 6.0%. This performance is influenced by heightened expectations for U.S. interest rates, which bolstered the dollar.

Moving forward, the investment landscape hinges on whether the improved inflation news will continue, allowing the Fed to start cutting rates in September, aligning with current market expectations. At the same time, the market is pricing a moderate pace of economic growth, although recent data suggests the economy is experiencing a slowdown. For equity markets, broad expansion beyond big tech has failed to materialize as expectations for earnings and continued stock performance in this cohort have been highly driven by artificial intelligence spending. However, equity valuations driven by large cap growth stocks are stretched such that any misstep might catalyze a pullback. The historically attractive level of bond yields should provide a balanced portfolio of stocks and bonds and offer a buffer in the event of a slowdown in the economy and lower interest rates.

Equity Performance:

By the end of the second quarter, the market trends from the first quarter were reestablished following a mild pullback in the month of April. The ongoing rally has continued despite fears that valuations are continuing to look frothy with the S&P 500 price to earnings (P/E) trading up to 21X and with market gains primarily concentrated in a select few stocks.

While positive at the aggregate index level, the stock market gains in the second quarter were less uniform than in the first quarter, during which every sector within the equity style box recorded positive returns. After narrowly beating growth stocks in the first quarter, value stocks lagged in the second. U.S. value stocks fell 1.47%, compared with a 2.42% gain for U.S. growth stocks. Reflecting the narrow reach of the rally, across the U.S. equity style box, only large-growth and large-blend stocks rose. The biggest losses came from small-cap value stocks, which sank 5.17%. However, over the past 12 months, every category is still in the green.



Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	6/30/2024
Index Level	1,527	1,565	3,386	4,797	5,460
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	21.0x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.4%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	4.4%

US Equity Style Box Performance

Q2 2024

	Value	Blend	Growth
Large	-0.59	2.00	4.73
Mid	-3.05	-2.61	-4.23
Small	-5.17	-4.16	-1.57

Q1 2024

	Value	Blend	Growth
Large	8.89	12.04	9.59
Mid	8.19	7.79	10.56
Small	4.64	7.13	5.29

1Y

	Value	Blend	Growth
Large	15.50	24.93	27.45
Mid	14.99	9.87	13.65
Small	10.85	10.81	10.97

Source: Morningstar

By industry group, gains were led by technology stocks, especially the companies seen as most likely to benefit from the artificial intelligence boom. Stock leadership for the overall rally continued to spring from the communications services and technology sectors. Technology and communications stocks continued to lead the market higher in the quarter. Tech stocks climbed 11.40%, while communication stocks saw gains of 9.16%. Defensive stocks were another bright spot, with consumer defensives up 1.11% and utilities up 4.48%. Cyclical stocks fell across the board, with the biggest losses coming among basic materials. Energy and industrial stocks plummeted after posting double-digit gains in the first quarter. With interest rates staying high, real estate stocks continued to struggle.

Stock Sector Performance

	Performance (%) Q2 2024	Q1 2024	1 Year
Cyclical			
Basic Materials	-5.88	8.06	7.35
Consumer Cyclical	-1.20	4.09	10.13
Financial Services	-1.74	12.23	26.19
Real Estate	-1.74	-0.70	5.30
Sensitive			
Communication Services	9.16	14.80	43.45
Energy	-2.19	13.25	16.49
Industrials	-3.41	10.94	15.77
Technology	11.40	13.07	40.41
Defensive			
Consumer Defensive	1.11	7.52	9.02
Healthcare	-1.02	8.36	10.59
Utilities	4.48	4.94	8.09

Source: Morningstar

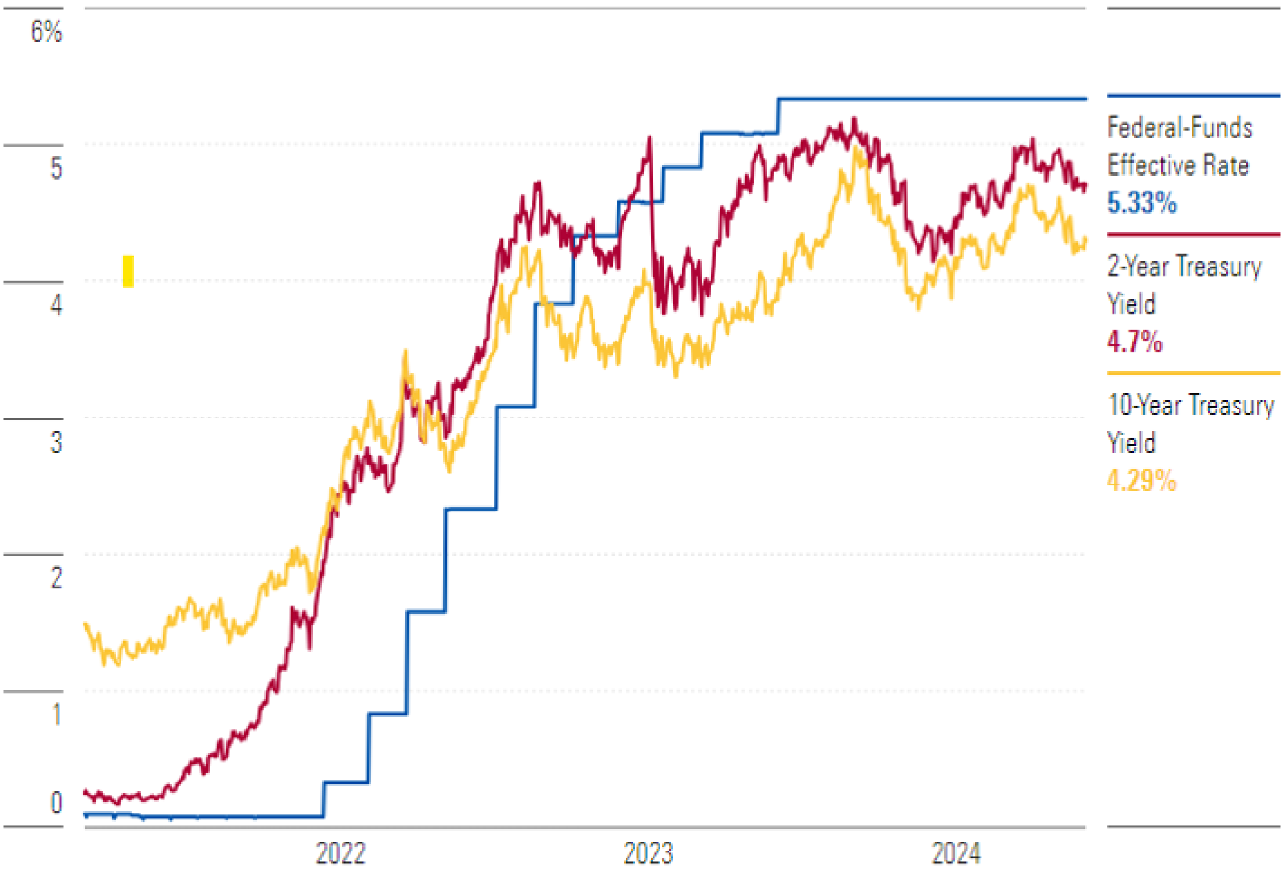
International equity markets sustained their upward trend in the second quarter, albeit at a slower pace, yet they still trail behind the broader U.S. market. U.S. currency appreciation continues to be a head wind to international returns on a local currency basis. International developed markets lagged emerging markets with European politics weighing on developed returns.

Returns	YTD 2024		2023	
	Local	USD	Local	USD
Regions				
U.S. (S&P 500)	-	15.3	-	26.3
AC World ex-U.S.	11.0	6.0	14.7	16.2
EAFE	11.5	5.7	16.8	18.9
Europe ex-UK	10.3	6.2	17.3	22.7
Emerging markets	11.2	7.7	10.3	10.3

Source: J.P. Morgan Asset Management

Fixed Income:

Market expectations for the Federal Reserve's next move have changed dramatically in 2024. The Fed has kept interest rates steady at a target range of 5.25%-5.50%, and investors have been anxiously awaiting signs that rate cuts could be around the corner. Bond futures markets started the year pricing in six or seven cuts in 2024, but stronger-than-expected inflation data forced investors to revise that estimate. Currently, markets are anticipating one or two cuts this year with a rising probability that the first cut could occur in September.



Source: Federal Reserve Economic Database. Data as of Jun 27, 2024.

Bond markets recovered in the second quarter, boosted by improving inflation and a firmer, more confident outlook for rate cuts. Yields on the 10-year Treasury note fell by more than 0.30 percentage points from their April peak, ending the quarter at 4.37%.

This decrease in yields has led to some price appreciation on bond holdings. The Core Bond Index gained 0.13% for the quarter, while high-yield bonds saw larger gains of 1.07%. However, longer-term yields lagged. With rate cuts on the horizon, strategists expect bonds to offer positive performance.

Morningstar Bond Indexes

	Performance (%)		
Core Bond	**Q2 2024**	**Q1 2024**	**1 Year**
Core Bond	0.17	-0.75	2.56
Sector			
US Treasuries	0.18	-0.86	1.58
Corporate	-0.07	-0.37	4.48
High Yield	1.07	1.53	10.50
Mortgage	0.22	-1.07	2.10
Municipal	0.27	-0.29	3.56
Maturity			
Short-Term Core	0.85	0.21	4.68
Intermediate Core	0.18	-1.00	2.34
Long-Term Core	-1.59	-2.33	-1.78
Inflation-Protected			
TIPS	0.93	0.05	2.75
US Government			
Short-Term Treasury	0.82	-0.02	4.16
Intermediate Treasury	0.19	-1.02	1.63
Long-Term Treasury	-1.65	-3.04	-5.66

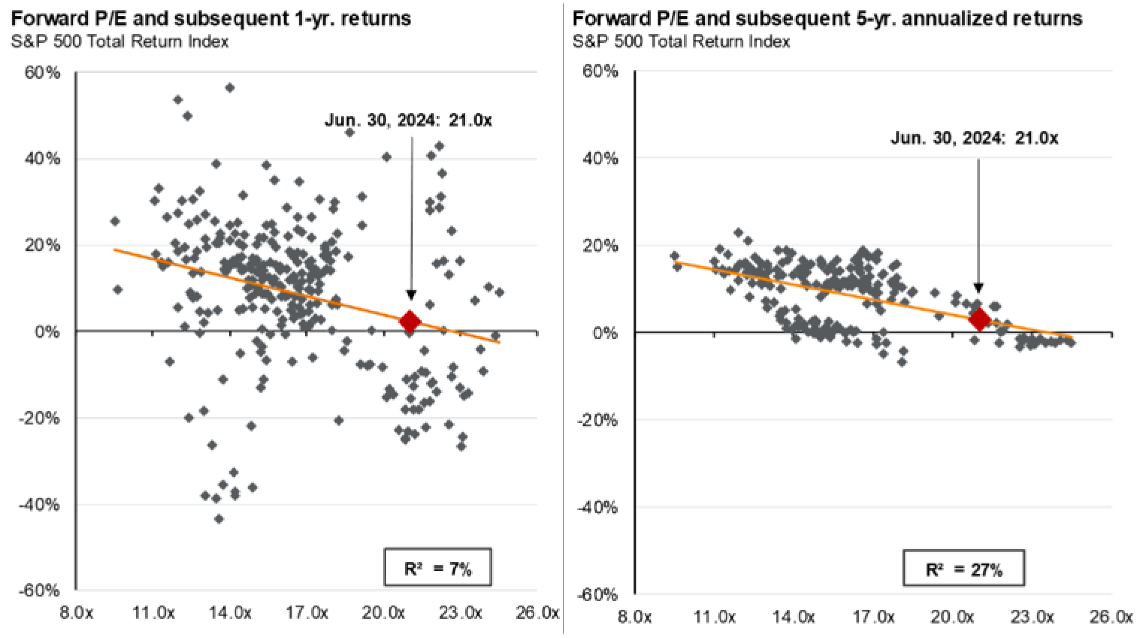
Source: Morningstar

Investment Outlook:

The investment outlook at the end of the second quarter is like the first quarter. The path of interest rates in the wake of one of the most aggressive monetary tightening cycles in history continues to be a central issue but softer economic data is also rising as a potential issue for corporate earnings.

Lower rates are seen as a catalyst for economic growth and support higher equity valuations, but a genuine slowdown in economic growth would alter the current financial market performance trends if earnings expectations are negatively impacted. For fixed income, and longer duration in particular, higher for longer interest rates have been a headwind. However, bonds now appear defensive in a scenario in which economic growth slows and positioned positively when rates cuts take place.

Outside of interest rates and economic trends, current equity valuation levels could play an increasingly important lever on the investment outlook. Given the current relatively high starting point for equity valuations, investors should expect a more modest level of return and likely increased volatility. Based on historical return patterns versus forward price to earnings (P/E) ratios, the current forward P/E ratio of 21X corresponds to a slightly positive but lower than average return over both a 1-year and 5-year basis, albeit with a wide range of dispersion over the shorter-term period.



Source: J.P. Morgan Asset Management

However, not all segments of the market are trading at a historical premium. While large cap growth stocks are trading at a nearly 50% premium to their 20-year average forward P/E, small cap value stocks are trading at a 5% discount to their 20-year average with other categories falling in between these book ends. So far, the premium for large cap stocks has been justified given the significant growth in their earnings relative to the market, mainly supported by artificial intelligence related spending. However, we are concerned that future earnings run the risk of disappointment relative to current elevated expectations and believe it is prudent for investors to diversify their equity exposure.

At Pallas Capital Advisors, we believe in adjusting portfolios based on recent investment performance and the current outlook. Beyond recent public equity market winners, we aim to broaden equity exposure, fixed income, and private market alternatives in a tax-efficient manner. We will continue to monitor macro and investment-specific idiosyncratic drivers to help deliver strong risk-adjusted returns that fit the goals of our clients on a 1-year and 5-year basis, albeit with a wide range of dispersion over the shorter-term period.