PALLAS
CAPITAL ADVISORS

PCA Quarterly Commentary

Q3 2023

Rising Long-Term Yields Casts a Shadow on Third Quarter 2023 Financial Performance

Major financial market indices retreated in the third quarter as the Federal Reserve discussed the possibility of maintaining higher short-term interest rates for an extended period, along with the rise in long-term bond yields and the resilience of the economy. What was once seen as positive news for the U.S. economy, propelling expectations higher in the first half of the year, turned into a headwind as expectations shifted towards the Federal Reserve potentially continuing to raise rates, postponing the prospect of lower rates far into the future.

Equity markets reached their yearly peak in late July but faced a downturn for the remainder of the quarter, closing near their lowest point. The broad U.S. equity market declined by over 3.2% for the quarter, with growth stocks falling by 5.9% and value stocks by 1.9%. For the year, the benchmark S&P 500 remained up by 13.1%, driven by a small group of mega-cap growth stocks, while small-cap equities saw only a 2.5% increase. Globally, developed market equities outside the U.S. also experienced a setback during the quarter and have now risen by 6.7% for the year.

Equity and Fixed Income Returns

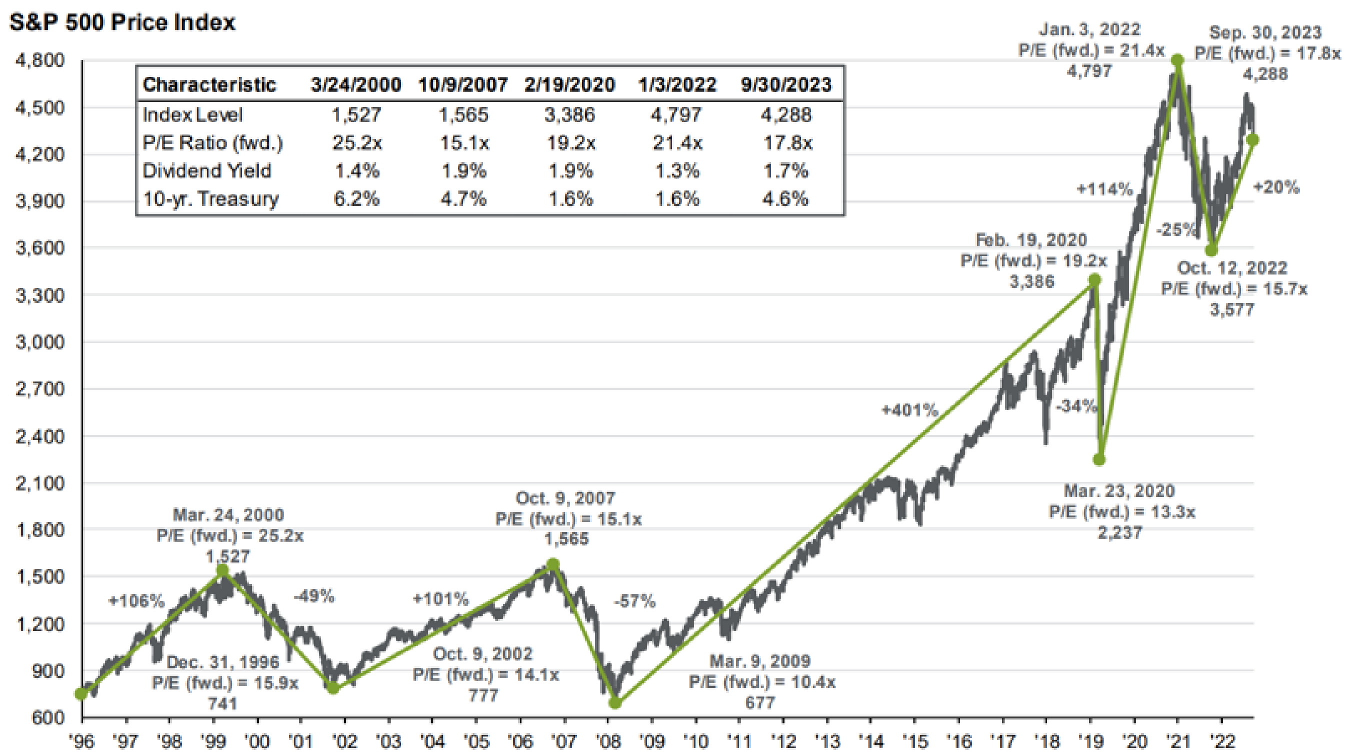
Annual Returns			Monthly Returns									
2020	2021	2022	Jan 2023	Feb 2023	Mar 2023	Apr 2023	May 2023	Jun 2023	Jul 2023	Aug 2023	Sep 2023	YTD
Small Cap Equity 19.96%	Large Cap Equity 28.71%	High Yield -11.19%	Small Cap Equity 9.75%	High Yield -1.29%	Global ex-U.S. Fixed Income 3.73%	Dev ex-U.S. Equity 2.84%	Large Cap Equity 0.43%	Small Cap Equity 8.13%	Emerging Market Equity 6.23%	High Yield 0.28%	High Yield -1.18%	Large Cap Equity 13.07%
Large Cap Equity 18.40%	Real Estate 26.09%	U.S. Fixed Income -13.01%	Real Estate 8.98%	Small Cap Equity -1.69%	Large Cap Equity 3.67%	Real Estate 1.89%	High Yield -0.92%	Large Cap Equity 6.61%	Small Cap Equity 6.12%	U.S. Fixed Income -0.64%	U.S. Fixed Income -2.54%	Dev ex-U.S. Equity 6.73%
Emerging Market Equity 18.31%	Small Cap Equity 14.82%	Dev ex-U.S. Equity -14.29%	Dev ex-U.S. Equity 8.20%	Dev ex-U.S. Equity -2.33%	Emerging Market Equity 3.03%	Large Cap Equity 1.56%	Small Cap Equity -0.92%	Dev ex-U.S. Equity 4.75%	Real Estate 3.74%	Large Cap Equity -1.59%	Emerging Market Equity -2.62%	High Yield 5.86%
Global ex-U.S. Fixed Income 10.11%	Dev ex-U.S. Equity 12.62%	Large Cap Equity -18.11%	Emerging Market Equity 7.90%	Large Cap Equity -2.44%	U.S. Fixed Income 2.54%	High Yield 1.00%	U.S. Fixed Income -1.09%	Emerging Market Equity 3.80%	Dev ex-U.S. Equity 3.24%	Global ex-U.S. Fixed Income -1.97%	Global ex-U.S. Fixed Income -3.30%	Small Cap Equity 2.54%
Dev ex-U.S. Equity 7.59%	High Yield 5.28%	Global ex-U.S. Fixed Income -18.70%	Large Cap Equity 6.28%	U.S. Fixed Income -2.59%	Dev ex-U.S. Equity 2.22%	U.S. Fixed Income 0.61%	Emerging Market Equity -1.68%	Real Estate 3.02%	Large Cap Equity 3.21%	Real Estate -3.35%	Dev ex-U.S. Equity -3.37%	Emerging Market Equity 1.82%
U.S. Fixed Income 7.51%	U.S. Fixed Income -1.54%	Emerging Market Equity -20.09%	High Yield 3.81%	Global ex-U.S. Fixed Income -3.99%	High Yield 1.07%	Global ex-U.S. Fixed Income 0.29%	Global ex-U.S. Fixed Income -2.69%	High Yield 1.67%	High Yield 1.38%	Dev ex-U.S. Equity -3.87%	Large Cap Equity -4.77%	U.S. Fixed Income -1.21%
High Yield 7.11%	Emerging Market Equity -2.54%	Small Cap Equity -20.44%	Global ex-U.S. Fixed Income 3.48%	Real Estate -4.41%	Real Estate -3.26%	Emerging Market Equity -1.13%	Dev ex-U.S. Equity -4.36%	Global ex-U.S. Fixed Income 0.26%	Global ex-U.S. Fixed Income 1.28%	Small Cap Equity -5.00%	Small Cap Equity -5.89%	Global ex-U.S. Fixed Income -3.20%
Real Estate -9.04%	Global ex-U.S. Fixed Income -7.05%	Real Estate -25.10%	U.S. Fixed Income 3.08%	Emerging Market Equity -6.48%	Small Cap Equity -4.78%	Small Cap Equity -1.80%	Real Estate -4.48%	U.S. Fixed Income -0.36%	U.S. Fixed Income -0.07%	Emerging Market Equity -6.16%	Real Estate -6.11%	Real Estate -4.88%

Sources: ● Bloomberg Aggregate ● Bloomberg Corp High Yield ● Bloomberg Global Aggregate ex US ● FTSE EPRA Nareit Developed ● MSCI Emerging Markets ● MSCI World ex USA ● Russell 2000 ● S&P 500

Source: Callan Institute

Emerging market equities displayed significant volatility throughout 2023, and this trend persisted into the third quarter. For the year, emerging market equities posted only a 1.8% gain. Similarly, U.S. aggregate fixed income returns fell by 3.2% for the quarter and 1.2% for the year. High-yield bonds, however, remained a bright spot in the fixed-income market, delivering a positive return in the third quarter and a 5.9% return for the year. This positive performance can be attributed to receding concerns about a recession, resulting in narrower risk spreads.

Despite upwardly revised earnings estimates, the pullback in equity prices caused the price/earnings ratio (P/E) for the S&P 500 to decrease to 17.8X at the end of the quarter, compared to 21.4X at the beginning of the year. While this level remains above the 25-year average P/E, it is primarily driven by the largest constituents of the index. The top 10 names in the S&P 500 index trade at a P/E of 25.9X, whereas the remaining stocks have a P/E of 16.8X.



Source: J.P. Morgan Research

While value stocks outperformed growth stocks in the third quarter, value continues to lag far behind growth on a year-to-date basis. The valuation divergence between growth and value stocks is particularly noteworthy with value stocks trading at a 20-year historical discount to growth stocks, only briefly matched during the nadir of the Covid stock-induced sell-off. Defensive sectors such as utilities and consumer as well as real estate (REITS) saw further absolute and relative underperformance in the third quarter. The underperformance of these sectors has been driven by valuation compression given the sensitivity to rising bond yields.

U.S. Equity Style Box Performance

Q3 2023

	Value	Blend	Growth
Large	-1.22	-1.28	-4.04
Mid	-3.92	-4.82	-6.42
Small	-3.18	-4.10	-6.46

Q2 2023

	Value	Blend	Growth
Large	4.06	5.27	12.80
Mid	2.50	5.03	6.48
Small	4.01	5.58	7.34

1 Year

	Value	Blend	Growth
Large	19.68	18.65	28.60
Mid	9.19	14.62	14.61
Small	10.11	20.13	12.59

Morningstar Sector Indexes

	Performance (%)		
Cyclical	Q3 2023	Q2 2023	1 Year
Basic Materials	-4.96	3.63	20.05
Consumer Cyclical	-4.69	12.14	16.05
Financial Services	-0.16	5.15	14.16
Real Estate	-8.46	2.30	-0.82
Sensitive			
Communication Services	2.51	12.59	36.44
Energy	12.66	-0.48	28.90
Industrials	-4.85	7.40	24.40
Technology	-4.91	16.48	40.99
Defensive			
Consumer Defensive	-5.22	0.56	8.16
Healthcare	-3.46	2.99	7.04
Utilities	-9.27	-2.75	-6.85

Source: Morningstar Direct. Data as of Sept. 30, 2023.

After fixed income returns stabilized in the first half of 2023, following historic negative returns in 2022, they experienced a setback, with the benchmark U.S. aggregate bond index declining by 3.2% and now marking a negative return for the third consecutive year. The strength of the economy has contributed to positive returns in public credit-exposed categories, such as high yield, and has also provided tailwinds for private credit. Short-term bond and Treasury yields have partially offset depreciation for both the quarter and the year, maintaining slightly positive total returns.

Morningstar Bond Indexes

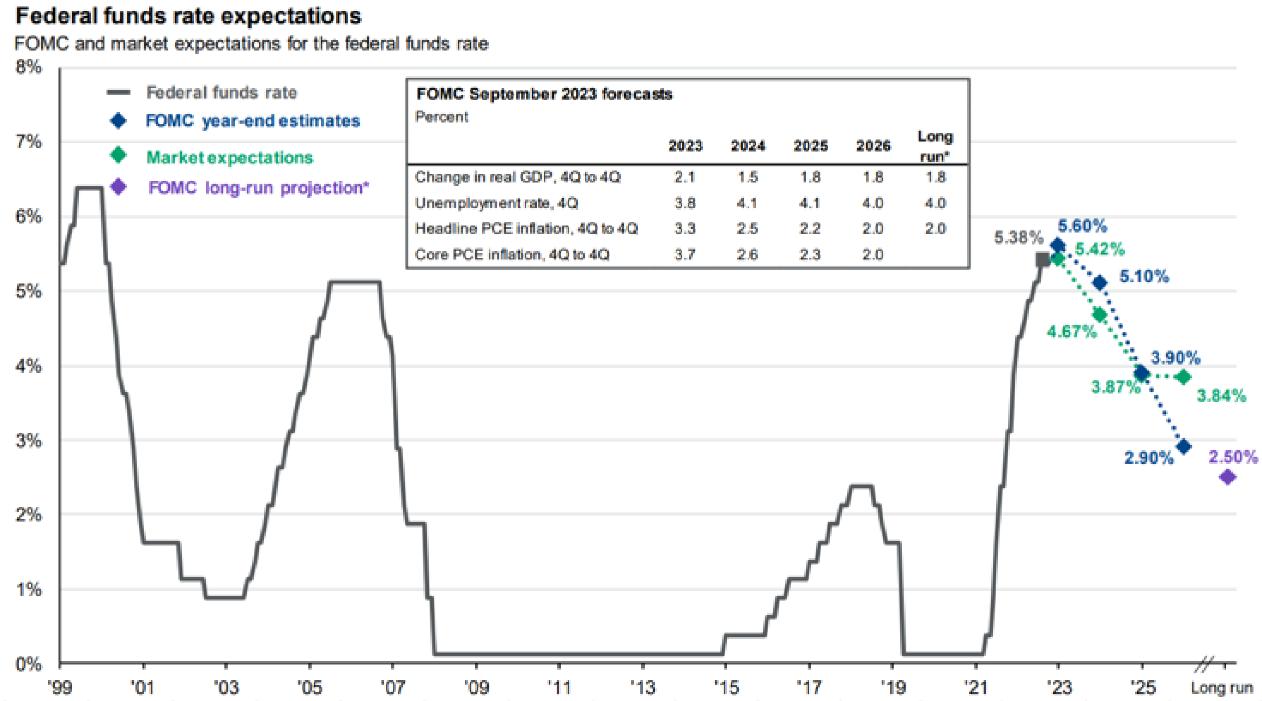
Core Bond	Performance (%) Q3 2023	Q2 2023	1 Year
Core Bond	-3.18	-0.82	0.66
Sector			
U.S. Treasuries	-3.01	-1.37	-0.78
Corporate	-2.99	-0.30	3.93
High Yield	0.57	1.65	10.30
Mortgage	-4.08	-0.53	-0.23
Municipal	-3.84	0.05	3.01
Maturity			
Short-Term Core	0.22	-0.60	2.63
Intermediate Core	-3.67	-0.82	0.27
Long-Term Core	-9.53	-1.32	-3.02
Inflation-Protected			
TIPS	-2.57	-1.45	1.29
U.S. Government			
Short-Term Treasury	0.21	-0.87	2.11
Intermediate Treasury	-3.11	-1.72	-0.57
Long-Term Treasury	-11.91	-2.35	-9.24
Floating Rate			
Leveraged Loans	3.46	3.15	13.06

Source: Morningstar Direct. Data as of Sept. 30, 2023.

The bond market pulled back during the second quarter from gains realized in the first quarter of 2023 as the Federal Reserve suggested more Fed funds rate increases are on the table. As yields went up, particularly among short-term maturities, interest-rate-sensitive bonds suffered. Long-term bonds—those due in 10 years or more, whose longer durations make them highly sensitive to interest rates—were hit hardest, but significantly less than experienced during 2022 as rates are seen as close to peaking.

Investment Outlook

While financial markets reacted positively in the first half of 2023 to better-than-feared economic and earnings resiliency and moderating inflation, good economic news and business resiliency turned into expectations for higher federal funds rates and higher long-term rates over a longer period. With the fear of an imminent recession being dismissed, long-term interest rate policy and levels have become the key drivers for financial asset performance. At the beginning of 2023, rate cuts were highly anticipated as a possibility before the year's end. However, there are no expectations for rate cuts in 2023, and further rate increases are still seen as a possibility. As higher rates for a more extended period have become the new norm, the belief in rate cuts has been pushed back to late 2024 and 2025. Confidence has also waned in expectations for lower rates, as financial markets adopt a view of structurally higher long-term rates following an extended period of perceived artificially low rates



Source: J.P. Morgan

Looking ahead, we believe that the rate of economic growth may slow due to tight monetary policy, reduced credit availability, and the eventual exhaustion of consumer spending—the primary driver of the U.S. economy. Mounting geopolitical instability and apparent dysfunction within U.S. governance add additional fuel to potential disruptions in both the U.S. and the global economy. Without the potential catalyst for lower interest rates, we suspect that the rate of market gains may be limited. However, we see the potential for slower economic growth to be favorable for further slowing inflation, which should provide valuation support for both equities and fixed income.

In terms of positioning, we believe there are opportunities in remaining invested with exposure diversified across equity styles. Given the performance dispersion that has occurred year-to-date, we still believe that the stage is set for improved relative performance from year-to-date laggards, such as defensive and dividend growth equities.

Growth equities that can support relatively rich valuation levels with faster underlying earnings growth and free cash flow should also remain attractive.

Fixed income also remains historically attractive. The yield curve inversion has flattened, making shorter-duration fixed income and even money market accounts less advantageous on a current yield basis. While this has weighed on longer-duration values, which move inversely with yields, we continue to believe that inflation will likely decrease over time, providing a catalyst for the eventual easing of the Federal Fund's rate and a clear potential for appreciation in longer-duration bonds.

Sincerely,

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

Bloomberg Corporate High Yield Index measures the market of USD-denominated, non-investment grade, fixed-rate, 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.

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

The FTSE EPRA Nareit Developed 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. Relevant real estate activities are defined as the ownership, trading, and development of income-producing real estate.

MSCI Emerging Markets Index is a free float-adjusted market-capitalization-weighted index that is designed to measure equity market performance of 24 emerging market countries.

MSCI World ex USA Index captures large and mid-cap representation across 22 of 23 developed market countries—excluding the United States. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

Russell 2000 Index measures the performance of small capitalization U.S. stocks. The Russell 2000 is a market value-weighted index of the 2,000 smallest stocks (#1,001–3,000) in the broad-market Russell 3000 Index.

S&P 500 Index measures the performance of large-capitalization U.S. stocks. It is a market-value-weighted index of 500 stocks that are traded on the NYSE, NYSE MKT, and Nasdaq.