PACIFIC FUNDS insights
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READY TO DECLARE A V-SHAPED RECOVERY?

With the economy slowing in September, the battle for a quick rebound may be far from over.

On Oct. 7, we sat down with Pacific Asset Management's Dominic Nolan, senior managing director, and Ryan Smith, client portfolio manager, to get their insights on the markets' performance in September; the health of the airline, restaurant and retail sectors; and the latest in the race for a COVID-19 vaccine. Pacific Asset Management LLC is the sub-adviser for the Pacific Funds℠ Fixed-Income Funds.

Dominic, September was a little rocky for investors after five straight months of outsized gains. From 30,000 feet, what happened?

We essentially had some market volatility around the increase in COVID-19 cases. Also, the federal government's expiring stimulus package factored into a stalling recovery. Overall a strong quarter for asset, but a rocky month.

Here is a stat for you. Since 1940, each time the stock market rallied more than 15% in a quarter, the average return of the S&P 500® index was 9% for the following quarter. In other words, the markets were up every single time after a major rally. For the third quarter of 2020, the S&P 500 finished up 9%—exactly the historical average. That's amazing. But it's important to note that the S&P 500 was off almost 4% in September, but, again, it did finish the quarter up 9% and year-to-date is up 5.5%.

Are large-cap companies still leading the way?

The Russell 1000® Growth Index continues to be the market leader. Though digital and tech companies were off almost 5% in September, the index finished the quarter up 13% and is up over 24% year-to-date. They continue to dominate.

Conversely on the value and smaller-company side, Russell 2000® Value Index is off about 4.5% in September (about the same as large cap), and up only 2.5% for the third quarter. Year-to-date, the index is down 21%. So the digital large-cap companies are up 24%, and traditional smaller value-based companies are down 21%. In my opinion, that really illustrates what's going on with businesses and the economy.

One interesting note was emerging-market equities. The MSCI Emerging Markets Index was off 1.5% last month, but up almost 10% for the quarter and now is just down a percent year-to-date. So, we're starting to see a little bit of pickup internationally.

What about the performance of bonds?

The Bloomberg Barclays U.S. Aggregate Bond Index was basically flat for the quarter, finishing up about a half percent. But for the year so far, it's up 6.8%. It's still outperforming the S&P 500, but largely due to rate movements earlier in the year. High yield was weaker in September, down a percent, but for the third quarter was up 4.5% and positive year-to-date. Bank loans were up in September—coupon returns were up about 60 basis points for last month, but up 4% for the quarter and down less than a percent year-to-date.

In general, the third quarter of 2020 was quite strong, led by large-cap growth and more aggressive fixed income. You wouldn't think by looking at these numbers there was a global pandemic and, six months ago, the worst economic quarter in modern history.

Can you give us what's going on with Federal Reserve (Fed) programs enacted to combat the pandemic-fueled economic downturn?

I'll give you a quick update on the Fed's Primary Market Corporate Credit Facility and the Secondary Market Corporate Credit Facility. Those facilities were announced on March 23, which correlated with the bottom of the market. That wasn't a coincidence, in my opinion. Between May and August, the Fed bought about

16 different corporate-bond ETFs totaling about $9 billion. But in August, they didn't make any ETF purchases. As it stands today, the primary facility still has not executed a trade, so they haven't bought a bond. The secondary facility has purchased about $15 billion in corporate bonds.

Combined, they've utilized just $15 billion or so out of a capacity of $750 billion. It's just a drop in the bucket. They did pick up purchases a little bit during September, and I think that had to do with market volatility and adding a little bit of a buffer. The Fed has extended the expiration date of the credit facilities from the end of September to the end of the year. The expectation is that they will extend those facilities well into 2021. There really isn't a reason not to. As the market needs it, maybe they step in on the secondary side.

Have the credit facilities operated as expected?

What's interesting is expectations when they launched the facility was that they would buy $50 to $100 billion in corporate bonds. Now expectations are they will only buy around $25 billion. The reality is the markets are functioning pretty normally on the investment-grade side. Companies can access liquidity, and the Fed hasn't needed to step in. The Fed's signaling has been the big tailwind for credit markets. Companies feel comfortable issuing bonds and getting liquidity with the Fed serving as a backstop.

Are we still on track for a V-shaped recovery?

Let me give you some comparisons between May and September that show us where we are right now. Back in May, restaurants were down 25 to 30% year-over-year. Now they're just down about 10%.[1] Transit was down 50% year-over-year in May. Now it's down about 25%.[2] Gasoline, which is a great measurement, was off 35% in May. Now it's down about 15%.[3] Clothing was off 20% in May. Now, almost flat.[4]

I think up until September, the data would say yes. The continuation of the recovery is really predicated on a second stimulus package in my opinion. With a stimulus package, and given the expectations for an increase in cases given children going back-to-school and cooler temperatures, October and November represent a stall.

What is the hardest hit sector that is not seeing a rebound?

Entertainment. Our research shows it was off 90% in May and is still off 70% year-over-year. I do think more government stimulus is going to be needed as we enter the colder months as we expect COVID-19 cases to increase.

Let's talk about some sectors that are top-of-mind with investors and the public. What about the airlines?

They saw a pretty good rebound April through July. Many of the airlines thought the rally was going to continue. But demand started to plateau in August when COVID-19 cases began to increase again. Since then, according to TSA checkpoint travel numbers, passenger traffic has hovered around 30 to 35% off prior year levels from July to July. That's been disappointing. For the third quarter, domestic capacity was down 50% year-over-year. International was down about 80%.

Now let's look through to the viability of the companies and their burn rates as reported in their quarterly earnings. In the third quarter, Delta Air Lines burned about $27 million a day in cash; United Airlines about $25 million a day, and American Airlines about $35 million a day. American certainly is the standout as far as burn. Those burn rates are not improving now. As demand has plateaued, so have the burn rates. There's likely a need for more support.

The Cares Act expired at the end of September, just a few weeks before the presidential election. The Cares Act's original $50 billion for airline bailout was divided:

[1]"Restaurant Performance Index." *Economist's Notebook.* National Restaurant Association, Sept. 30, 2020.
[2]"COVID-19 Related Transportation Statistics." *Bureau of Transportation Statistics.* United States Department of Transportation, Sept. 18, 2020.
[3]"Gasoline and Diesel Fuel Update." *Petroleum & Other Liquids.* U.S. Energy Information Administration, Oct. 2, 2020
[4]"Monthly Retail Trade." *Business & Industry.* United States Census Bureau, Sept. 30, 2020.

about $25 billion in grants and $25 billion in loans. Everyone accepted the grant. It came with restrictions such as no layoffs, and a portion of it needed to be repaid. But not all carriers accepted the loan. Southwest Airlines and Delta Air Lines actually rejected them.

As it stands now, U.S. Treasury Secretary Mnuchin and House Speaker Pelosi are in talks for a second airline bailout of around $25 billion, but there are no firm details yet about the negotiations. In the meantime, with the Cares Act expired and restrictions lifted on keeping employees, the airlines have started to layoff workers, but indicated that they will hire them back if they receive additional aid.

In reality, nothing really concrete has changed since July as demand has stagnated, and that's bad. Every day they're burning this cash, so every day, in theory, the value of these companies should decrease. Right now, I think the critical part to this is more stimulus, and the discussion around layoffs and hiring as it relates to the stimulus. That, to me, is the event that could change the trajectory of the airline industry.

Okay, what's the condition of retail right now? It seems grim.

It is. Twenty-seven major retailers have filed for bankruptcy in 2020 so far. In comparison, 17 filed all of last year. By mid-August, 10,000 stores announced their closing. All of last year, roughly 9,500 stores closed.[5] So, this year we've already surpassed that. Now, mind you, retail was weak going into this, but it's estimated that stores closures could reach 25,000 by year's end.

In the retail sector, if you're not an essentials provider such as a Target, Walmart, or Amazon , it's problematic.

Does the restaurant industry look any better?

Not by much. Barclays, a solid restaurant analyst, estimated as of Sept. 17 that about 10% of restaurants will close in 2020, and those closures will be skewed heavily toward casual eateries and independent restaurants.

In the three sectors you mentioned—airline, retail and restaurant—tens of thousands of jobs will be lost.

Yes. They are massive employers of service-based workers. Those are the jobs that, I think, are going to be very difficult to get back. Those industries, especially retail and restaurants, are going through a transformative change. That tells me unemployment will probably stay elevated once we get to a new plateau.

Obviously with a vaccine and improved economy, you'll get that unemployment spike down, but structurally those industries are changing. And my guess is the number of service-based employees will be fewer a year or two from now, even as the economy recovers.

Ryan, you closely follow developments on potential COVID-19 vaccines, which would give a major boost to the economy once widely available. What are the experts saying about when a vaccine will be ready?

It's a bit of a moving target, but there are some dates that the pharmaceutical companies have provided. You've got three major trials underway: Moderna, Inc., Pfizer Inc., and AstraZeneca, which has paused its U.S. trial.

Let's start with Moderna. They've enrolled 30,000 participants. To determine if their vaccine is effective and meets the FDA standards, at least 150 people need to be infected over the course of the trial. Moderna expects to conduct and complete what's called an "interim analysis" of 53 infected participants by the end of November. At that point, if the vaccine has proven effective (has 74% efficacy), Moderna can declare the trial a success and, at that point, seek FDA approval.

Turning to Pfizer, they've enrolled more participants, 44,000, and 164 of them need to be infected over the course of the trial to determine whether the vaccine is effective. Pfizer has set an aggressive timetable—as early as the end of October—to finish their interim analysis of 53 cases. Because of the larger sample size, they would need 77% efficacy to move to FDA approval.

[5] *The running list of 2020 retail bankruptcies.* Retail Dive, Sept. 14, 2020.

If any of those vaccines prove highly effective, the timetable for approval could be substantially pushed up. The main determinant is how quickly 53 participants in each trial contract COVID-19.

That said, it's likely that a widely available vaccine won't be ready until 2021.

On the therapeutic side, Eli Lilly and Company has already applied for FDA approval, and Regeneron is seeking FDA approval. That's good evidence that those studies are moving along with effective results.

Back to Dominic. Considering the stock market volatility in September, where does that leave the credit markets?

Markets are still wide relative to entering the year. And if you think about capital markets, when you remove tech, you get a more accurate reflection of the current economic situation. But because the tech stalwarts have been so dominant, the broad industry returns look pretty decent. Again, small-cap value is off 20% and bankruptcies are way up, but the economy is doing well.

Credit is really in the middle because you have liquidity support from central bank. The pace of downgrades and defaults have certainly slowed relative to the spike at the end of the first quarter and the beginning of the second quarter. BBB spreads are still wide by 50 basis points year-to-date—and they're offering almost 200 basis points spread to Treasuries, which in a world where you look from an absolute standpoint, that's attractive. From relative standpoint to Treasuries, credit is even more attractive, offering two to three times the yield. Again, these companies have been able to tap liquidity and with so many smaller companies either restructuring, or vanishing, the larger companies can probably end up taking more market share.

When you dig into high yield, yields are creeping to the high fives again, and, year-to-date, their spreads are still wider. Again, Double B spreads, Single B spreads are still wider by 70 to 80 basis points. The high-yield index is yielding 5.5 to 5.7%. In this world, I think those are still decently attractive yields.

My guess is that we should technically have wider spreads this year given what's happened in the global economy. But it also means that if you have a successful treatment of COVID-19, you might get some compression on the spread side.

Any last non-economic thoughts?

I'll start with a little legal story, and it goes back to 1971. There was a case called Reed v. Reed. Essentially, there was a lady by the name of Sally Reed who thought she should be the executor of her son's estate instead of her ex-husband. The case made it up to the Supreme Court. It was a constitutional issue as to whether a state could automatically prefer men over women as executors of estates. And the answer from the all-male Supreme Court was no. It was the first time the court had struck down a state law because it discriminated based on gender.

The person who wrote the brief for Sally Reed was Ruth Bader Ginsburg (it was her first Supreme Court brief). Again, that was 1971. Over many decades, Justice Ginsburg has been an amazing American, an icon, a historic figure who fought the good fight. So, I'll take one of her quotes as the non-economic thought.

She said, "You can disagree without being disagreeable." Our country is in a time where we're trying to fight a health crisis, there is social discord, and there are a lot of ill-tempered, unfriendly words and actions toward one another. There's no need for that. And so, to honor the Notorious RBG, "You can disagree without being disagreeable." I'll leave you with that.

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