PACIFIC FUNDS insights

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FAREWELL 2020

Vaccine and stimulus hopes propelled markets higher in November, despite the surge in COVID-19 cases.

On Dec. 10, 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 November and potential opportunities into the new year.

Markets seem to have turned a corner in November after news of the imminent arrival of COVID-19 vaccines. Can you put last month's economic performance in perspective?

November was a pretty robust month for the markets. The S&P 500® index was up almost 11% and is up 14% year-to-date. Since the bottom in March, the index is up over 60%, an amazing run in my opinion. An interesting part for me was the change of market leaders. The Russell 1000® Growth Index, which is up over 30% for the year, underperformed the S&P 500 in November, despite being up 10.25% last month. Even though the Russell 1000 Growth tends to get most of the news because of large-cap tech stocks, it actually hasn't done well over the past three months, up only 1.48% vs. the S&P 500 return of 3.9%.

Conversely, the Russell 2000® Value Index, which had been an immense laggard for most of the year, was up more than 19% last month and is now down only 3% for the year. There's still a 35% difference between Russell 1000 Growth and the Russell 2000 Value this year, but you've seen a 16% makeup over the past three months.

What about bonds?

The Bloomberg Barclays U.S. Aggregate Bond Index was up 1% for the month and remains up a little over 7% for the year. The highest performer in November was high-yield bonds, which were up almost 4% and, for the year, are up more than 5%. Bank loans also did well. They were above coupon, up a little over 2%. So, almost all the indices are up for the year (except the Russell 2000 Value). We've had a huge run since March, and momentum continued in November with the vaccine news.

Some significant Fed-related news was generated in November. First, what do you make of the unexpected announcement that the Primary and Secondary Market Corporate Credit facilities will be closed at the end of the year?

When the opening of the credit facilities was announced on March 23, the S&P 500 was at 2,237. Today, it's at 3,669—a 64% increase. Initially, the facilities were set up to purchase up to $250 billion in corporate debt, and in April that was upsized to $750 billion. But interestingly enough, the Federal Reserve (Fed) didn't actually buy a single bond until May. And through November, the secondary-market facility had purchased about $14 billion, while the primary-market facility still had not purchased any bonds. The takeaway is that the Fed's signaling had an immense impact without actually deploying a significant amount of money into buying bonds.

In November, U.S. Treasury Secretary Mnuchin let the Fed know the facilities would be shuttered at the end of the year. The decision, I think, could have been done more transparently because it surprised the markets. These facilities essentially cannot be restarted without congressional approval, and, in my opinion, that gives Congress, in particular, the Senate, a bargaining chip should the need arise next year.

What about the announcement that former Fed Chair Janet Yellen will be the new U.S. Treasury Secretary?

The market considers this a positive. Yellen is viewed as pragmatic, dovish, and certainly cooperative with the Fed, being that she was the former chair. Certainly, the market has viewed the appointment as accretive for economic growth.

Can you provide us updates on some of the COVID-impacted sectors?

According to information from the Bureau of Economic Analysis, generally speaking, total credit card spending has increased 5% in early December year-over-year (from Dec. 2019). For airlines, lodging, and gas, there's really no change in recent months. For instance, airlines in October were down 65% year-over-year, and in December they were also down 65% year-over-year. We haven't seen any progress on that front.

As you can expect, restaurants and bars have deteriorated since October given the latest COVID surge. Restaurant and bar spending were down 4 to 10% year-over-year, depending on the day. In the first week of December, restaurant and bar spending were down anywhere from 12 to 26% year-over-year. We are definitely seeing the impact of the latest lockdowns. This is another indication of why stimulus is going to be important for a lot of businesses and employees. Not surprisingly, grocery spending is up 13% year-over-year, compared to up about 6% in October year-over-year.

In November, department store spending was down about 5% year-over-year. This is no surprise with stores closing, and people hesitant to go shopping in person. In October, online spending was up almost 70% year-over-year, and that held in November. For December so far, online spending jumped 100% year-over-year.

All of this isn't a big surprise. People are eating out less, people aren't going to malls as much, people are spending more at the grocery store, and more people are shopping online. It's déjà vu. The current COVID surge makes me feel like we're back in March or April. The big difference today is that vaccines are on the way.

So, at this point, what are the more attractive opportunities you see in fixed income?

I'll start by sharing a data point on fixed income that came from our high-yield portfolio manager. If you were to start at the end of the third quarter through last week and tiered the prices of high yield bonds, bonds priced $80-$100, generally considered performing bonds, were up 4.7% on average. Bonds priced $70-$80 were up 20.4%, $50-$70 were up 22.6% and $0-$50 were up 39.2%.

Digging further in the "everybody gets a prize world," there were 69 securities priced between $70 and $80, and only 1 was down for the period. These are bonds that many consider "distressed," so the companies are generally not performing well. To me, it's a sign of massive global liquidity.

To reflect where we sit today, high-yield spreads blew out to 1,100 basis-points spreads earlier this year. Now they're almost down to 400. You're starting to see sentiment be so positive that there's not much more to go for next year. You might see some coupon-clipping expectations on the high-yield side because it's going to be tough to get spreads to tighten further.

On the investment-grade side, it's more coupon-like expectations. This does lead an interesting play in floating-rate loans. If you're of the belief the economy is going to grow significantly next year, and you think interest rates will begin to tick up given the COVID-19 vaccines and economy reboot, then you actually have a good defense mechanism via decent income in floating-rate loans. Floating-rate loans have yielded less than high-yield bonds to the tune of about 40 to 50 basis points.

Well, that's flipped. High-yield right now is yielding 40 basis points lower than loans. Historically, that tends to favor the bank-loan side. Again, they are largely

immune to interest-rate swings. Whether or not interest rates go up is a much more complex question. I believe there is certainly an argument that loans are attractive relative to fixed instruments because the fixed instruments have rallied so much this year.

We're about to say farewell—or good riddance—to 2020. What's your last non-economic thought for 2020 as we head into the holiday?

I've had this conversation with my kids. It's easy to find inconveniences, frustrations and heartache this season given what we've been through as a country and a society. But we can flip that and say, "This year should not be about the list of things we want, but rather a list of things we have." Simplify. Do less, not more. Focus on giving, not receiving. Give memories, not materials.

As the year ends, hopefully we can spend time reflecting on our blessings of this year.

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