PACIFIC FUNDS

insights

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CAN 2021 BE A CURE-ALL?

With vaccines rolling out and the U.S. Senate picture clear, what may the markets look like in 2021?

On Jan. 7, we sat down with Dominic Nolan, senior managing director of Pacific Asset Management, to get his insights on the markets' performance in December and what the markets may have in store for investors in 2021.

What are your thoughts on how the market ended in 2020?

Let's start with the S&P 500 Index. In December, it was up almost 4%, and, for the fourth quarter, it was up a little over 12%. For all of 2020, the S&P finished up 18.4%. That's an amazing year, and I think if you'd asked people in March what the expectation was, you would have a dramatically different number.

Can you dig a little deeper for us?

Looking below the surface, the tech sector was up about 4.5% for December, slightly outperforming the S&P. The Russell 2000 Value Index was up almost 8% last month. So those smaller, suppressed businesses on the value side continued their market leadership. For the fourth quarter, the Russell 1000 Growth Index was up 11%, and the Russell 2000 Value Index was up 33%, outperforming its large growth counterpart by over 20%. Russell 2000 Value ended the year up 4.6%. However, Russell 1000 Growth was up 38.5% for the year. That tells me if you expect some reversion to the mean, there still could be quite a bit more to go for Russell 2000 Value, especially as the economy opens up.

Internationally, emerging-market equities were up about 18% for 2020, on par with the S&P. Foreign developed markets were up about 8%.

What about bonds?

Bloomberg Barclays US Aggregate Bond Index was up a measly 14 basis points in December. For the fourth quarter, it was up 67 basis points. For the year, it ended up 7.5%. This was predominantly due to the interest-rate move early in the year.

High-yield bonds were the clear winner in the fourth quarter, up 6.5% and, for the year, up 7%. Almost all gains in the high-yield bond market occurred in the fourth quarter. Again, that's a pretty big move.

Bank loans also put on a rally because, I think, they're a little more immune to interest rate moves. Loans in December were up about 1.3% and 2.8% for the year. Loans were below coupon in 2020, high yield seemed to be right around coupon. They're starting to gain some ground, but lagged for the year.

Let's talk politics. We have a Democrat in the White House and Democratic majorities in the U.S. House of Representatives and Senate. What do you see as the potential market implications?

Entering 2021, I would say that the biggest risk to fiscal policy would have been an "austerity" mentality if the Senate remained under GOP control. With Georgia voting in two Democrats this month to the Senate, that risk has been reduced dramatically. Now you have a much clearer path to push through whatever fiscal measures the new administration wants to push through. A new dynamic is with a split Senate, moderate senators willing to work with the other side have more leverage, which will make things more interesting.

What else can we expect?

From a policy standpoint, there's a lot of new things being underwritten with the Senate moving blue. The new base case has increased stimulus and spending,

which increases the pressure on interest rates as inflation expectations will be a bit higher.

You would expect the dollar to be weaker with this, but what's happening is the dollar is fighting the balance between inflation expectations and what the market believes the Fed will do in later years around rate hikes. If the expectation becomes that the Fed will hike interest rates sooner, that would argue the dollar may essentially hold the line.

As relates to stimulus, I expect that Congress will authorize another stimulus check to bridge the gap between the recently approved $600 check and the $2,000 check that Congress and President Trump sought.

Beyond that, Congress and President Biden will be trying to enact a longer-term infrastructure package, which the Biden campaign labeled "Build Back Better." That leads to the questions: What will be the extent of an infrastructure package and how will those funds flow to certain sectors of the market? With the White House and Congress now blue, industrial companies, material companies and chemical companies have higher expectations. There are also rumors there may be a first-time homebuyer credit, which should help homebuilders.

There are other unknowns going forward. For example, what's the probability of a corporate tax hike or an income tax hike? How will the trade relationship with China unfold under President Biden? With Democrats in control of Washington D.C., those are things the market now is re-underwriting.

We're experiencing a third surge of COVID cases, and states are undergoing new rounds of restrictions. How is this impacting various sectors of the economy? Let's start with travel.

Sure. I'll use consumer spending data as tracked by Bank of America. Let's compare earlier December with late December.

Lodging was down 40 to 50% , and we didn't see that change in December. We did see a little improvement in gasoline. Gas was down 15% year over year at the beginning of December but was down about 10% at yearend. It looks like people were traveling less by planes due to COIVD outbreaks and more by car, probably to spend time with family and friends over the holidays.

Where were the bright spots?

I would say the areas that have seen improvement or continue to see year-over-year improvement include groceries (still up double digits), home improvement (up 32%), and online retail (up 70%). All that makes sense as it's consistent with consumer behavior we have seen during the pandemic.

Areas of concern?

We continue to see bad news for restaurants and bars. Restaurants were down about 12% at the beginning of December, and, by the end of the year, they were down 20% year-over-year. Department stores were off about 5% year-over-year at the beginning of December. By Christmas, they were off almost 20%, until Christmas Eve, thanks to last-minute shoppers.

Like most people, I'm anxious to watch these sectors as the vaccines reach a large portion of our population in late winter or early spring. That's when the numbers will start to matter more.

Given your expectations on 2021, where do you see opportunities in fixed income?

I'll start with framing the economic environment at a high level. We have monetary accommodation, and the central banks will continue to have massive quantitative easing. If you're looking for expectations on fiscal spending, I think that you can glean something from the second stimulus package. The House of Representatives and President Trump wanted $2,000 stimulus checks, and the GOP-led Senate blocked that in favor of $600 checks. If this new Senate gets onboard, we will have more spending.

Also, consumer net worth is up 18% year-over-year, a combination of the rising stock market and home prices. If you believe in the wealth effect, that is a massive percentage increase for consumer net worth. And then you have the vaccine rollout. So, at a high level, those are pretty constructive things economically: an accommodative monetary policy, increasing consumer

net worth, the arrival of vaccines, and rising house prices.

Okay, now what does that mean for credit? Well, it should be good for spreads. I would expect spreads to continue grinding tighter across the board—high yield, investment grade and bank loans. However, the offset to that is the possibility of increasing interest rates. I wouldn't expect a huge spike in rates, but it would offset some of the spread compression in investment grade and high yield. As it relates to credit, credit is still very attractive relative to most other paper and, in my opinion, does throw in a more interesting or more compelling story for a floating rate.

With regard to floating-rate assets, I like to categorize it as defensive yield. The interest-rate carry is higher than high-yield bonds at this point, but without interest-rate risk and better positioning in the capital structure. Given the constructive story for credit and the mixed outlook for rates, a pure credit play is compelling, which is floating rate loans.

As usual, can you end by sharing a non-economic thought?

A close friend of mine's father contracted COVID just before Thanksgiving. And as we speak today, he's in a very tough fight. Before being put on a ventilator in mid-December, the father said to his son, "I can't believe it. Just as these vaccines are approved, I'm going to be put on a ventilator."

That was sobering and made me reflect quite a bit. I feel like we just all need to hold the line a little bit more. We are so close to the time when we can get vaccinated.

In my family, we have been fortunate enough to avoid COVID, part by luck and part by intention, over the past nine months. Now we are talking about just holding the line for a little bit more. If you use a sport's analogy, I feel like we're in extra time in a soccer match. We're up 1-nil, but the attackers keep coming, and we're just trying to preserve the lead until the final whistle blows.

We're almost there. Having a friend's dad lament the unfortunate timing of his illness after avoiding COVID for nine months and having vaccines almost within reach, it reinforced in me that now, more than ever, is the time to hold the line.

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