PACIFIC FUNDS insights

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LOOMING BATTLES

Perspectives on stimulus, consumer spending, and defaults.

On Feb. 4, we sat down with Dominic Nolan, senior managing director of Pacific Asset Management, to get his insights on key issues facing the U.S. and world economy.

To start off, can you give us a rundown on what happened in the markets in January?

We had some volatility, especially toward the last couple of weeks in January. I'll start with the S&P 500, which was down about 1% for the month. The Russell 1000 Growth Index was down about 74 basis points. The Russell 1000 Growth has now underperformed the S&P over the past three months. The MSCI Emerging Market Index finished down 1%. The winner for January was the Russell 2000 Value Index, which was up 5%.

When you look at the three-month performance, Russell 2000 Value is up 33%, while the Russell 1000 Growth is up about 11%. Essentially, market leadership has flipped.

One of the most astonishing figures is that the earnings on the S&P in the fourth quarter of '20 are going to come in around $165. Folks, that is the same as fourth quarter 2019. That is a huge surprise. That puts a multiple on the S&P around 24. For the second quarter of this year, earnings are expected to be about $185. Year-over-year, that's 65% higher than the second quarter of 2020.

Earnings are actually doing fine. Factor in Central Bank support, the vaccine ramp up, a trillion-dollar stimulus package, and low interest rates,—all those things are constructive to economic growth.

Can you talk about the developments in Europe you mentioned?

Sure, and I think it's likely going to be very important. Mario Draghi—known affectionately as Super Mario—is expected to help form a new unity government in Italy. He's a very respected economist who gained fame as president of the European Central Bank during the European financial crisis in the 2010s when he promised he'll do "whatever it takes" to save the euro.

So perhaps there will be a different view of fiscal policy. Certainly, they'll have the European Central Bank support with Christine Lagarde as its president. Lagarde, Draghi and Angela Merkel, the chancellor of Germany, will all be supportive on a quantitative-ease or EQ side, but from a fiscal-policy side, Europe still has that austerity mindset. Draghi might be able to help pivot that to drive economic growth. So, keep an eye on Draghi developments, which I think will be accretive to economic growth.

How did bonds perform in January?

The Bloomberg Barclays Aggregate Index was off 72 basis points as rates rose again after the Georgia Senate elections. High-yield finished up about 30 basis points, floating-rate bank loans were up over 1%, and was the leader within fixed-income. Once again, the rate environment is quite uncertain right now. However, the credit environment seems to be improving or tightening.

Let's turn to the Federal Reserve. Did we get anything meaningful from its January comments?

No surprises. From Fed official comments in January, they expect QE purchases to continue through this year. Right now, they're increasing the balance sheet by $120 billion a month. That's $80 billion in Treasuries and $40 billion in mortgage-backed securities. The Fed's balance

sheet is now over $7 trillion.

President Biden and Congress are trying to craft a new stimulus package to provide additional help to Americans during the pandemic. How do you see this shaping up?

Well, I think the stimulus package is the first real policy battle between the new administration and Congress—and battle might be too strong of a word. But you have the Democrats proposing a $1.9 trillion package, and the GOP coming in at $600 billion.

The administration seems to be anchored to $1,400 stimulus checks. However, they have stated they are open to tightening the criteria for who receives the check. What does that mean? You still keep the $1,400 check maximum, but you could cut the tiering of payments based on means and/or you could cut the eligibility of families. That could certainly reduce the $1.9 trillion number.

Also, keep an eye on state aid. Right now, the bill has $350 billion going to states, but as most of us are aware, the real estate market and housing market is doing quite well. As a result, state budgets aren't being impaired or affected as negatively as one would expect given the COVID-battered economy last year. Given that, there could be an argument to reduce state aid.

And I'm interested to see if the $15-an-hour federal minimum wage proposal is dropped from the stimulus bill. I would note that the Dems have begun what's called the reconciliation process, meaning that only 50 votes—not the standard 60—are needed to pass the bill. This procedure was put in place in 1974 to speed up certain legislation, including some kinds of spending. If the Senate goes through the reconciliation process, swing Senators might be able to have a lot more impact than they have before.

All that said, my guess is that we end up with a stimulus package that's in the low to mid trillion-dollar range.

We're seeing the number of new COVID cases dropping, as the vaccine program ramps up. How is this affecting the economy?

It's interesting as you're starting to see the impact from state economies reopening. And again, we're in the early stages of the vaccine rollout. There's a lot of confluence of things happening.

I'll start at a high level. These are all figures from Bank of America's credit-card data. Total credit-card spending in January was up about 5% year-over-year. Stimulus did play a role there. Bank of America calculated by the end of January, about 18% of the stimulus checks have been spent. When they go back and look at the April 2020 checks, 13% of the checks had been spent after 30 days. Now I would think from a relative standpoint, the January impact was a little higher, but the amount of checks was lower.

Are some regions of the country doing better than others?

Yes. There are now noticeable regional differences in the economic reopening. East of the Mississippi River, just three states were down in January (year-over-year) in credit-card spending: Wisconsin, Vermont, and Massachusetts. In the Western United States, California, Washington, Oregon, Colorado and four more states were down, and 14 states were up. The economies of the eastern half of the U.S. appear to be more open. If you dig down to the city level, Seattle, San Francisco and Portland were down the most. Meanwhile, Miami, Detroit, Atlanta and Chicago were all up, and Miami's spending was up more than any major city year-over-year.

How are COVID-impacted sectors doing?

In general, we're starting to see slight improvement in the airlines, lodging, entertainment, and restaurants sectors. We're seeing a slight dropoff in home improvement. Again, that's a reflection of the pandemic as that sector has done really well since last March. But restaurants and bars down roughly 10% year-over-year. Restaurant and Bar spending in California and New York was off almost 20% year-over-year. Meanwhile, restaurant and bar spending in Florida and Georgia was

up 5%. In the southeastern United States, people are going out.

Keep in mind that once we hit March and April, spending comparisons year-over-year will be heavily skewed. Assuming our economy is better in March and given the economic impact of COVID on March 2020, you're going to see some pretty dramatic increases in spending year-over-year.

Additionally, the airline, lodging and entertainment sectors may have ridiculously high growth numbers year-over-year come April. Meanwhile, home improvement and all the things that people were spending on during the pandemic could flip.

What should we watch for in fixed income?

The things to really watch are inflation and rates. Now the Central Bank is going to anchor the front end of the curve, but if inflation starts to rise, expectations have started to move up, yields start to move up. The Credit story is good, inflation picture is uncertain. You still have momentum in the floating-rate space. I'm still very constructive on credit, given those major tailwinds I just mentioned earlier.

A large component to consider when looking at floating-rate loans are defaults. Are they still elevated, or are we back to normal?

They're still a bit elevated but settling down. You have a ton of liquidity now for these companies. For anybody diving into floating-rate loans, one of the elements to consider is covenant light or cov-light, which essentially gives the lender less protection and allows the company to be less restrained.

Well, that's good and bad. The purpose of many covenants is to restrict how much leverage a company can borrow on and put guardrails around a company (or borrower). Well, the downside of covenants is that if a company trips a covenant, a lot of times lenders will accelerate bankruptcy. Over the past 10 years, you have had a wave of "cov-light" issuance from companies that don't want restrictions, which has been viewed, "Oh, that's bad." In my opinion, cov-light has helped companies avoid bankruptcy over the past year. It has given them the freedom to go and raise capital. Does leverage go up? Yes. So, you are seeing leverage go up, but what you will end up having, in my opinion, are less defaults, but lower recoveries. The default rates aren't as high as you would think, given the economy last year, but recoveries are also lower. And I think that trend will continue over the next year or two.

You do have companies that are broken. There are some retailers that will go bankrupt, and the pandemic accelerated this. With troubled retailers, you probably want them to default anyway because their business model was not equipped for the digital world.

However, there are certainly companies whose business models aren't broken, but have been badly hurt by the pandemic—for instance, airlines. They mostly need liquidity to get through this period of time. Now, given we don't quite know what the level of business air travel will be over the next five years, is it prudent for them to go into bankruptcy? We can debate the merits of capitalism and creative destruction, but there are certainly a lot of companies that simply need liquidity. And if they had tight covenants, bankruptcy may have been accelerated.

Finally, can you give us your non-economic thought for the month?

My non-economic thought has to do with New Year's resolutions. We're in first week of February, and surveys show that by now most New Year's resolutions have already been broken. So, what I want you to think about is that many times we give more to others than we give to ourselves. If we don't take care of ourselves, in the long-term, we end up giving less to others and ourselves.

My thought or suggestion is this: make a promise to yourself that you keep as if you made a promise to a friend or family member. Because so many times, we treat ourselves worse than we treat other people. If we were to tell a friend, "I'm going to take you to a show, or I'm going to take you to a game," you'll keep that commitment. But if we make the promise to ourselves, we often break it. So, make a promise to yourself to do something for yourself, especially as we emerge from this pandemic.

Definitions

One basis point is equal to 0.01%.

The Bloomberg Barclays U.S. Aggregate Bond Index is composed of investment-grade U.S. government bonds, investment-grade corporate bonds, mortgage pass-through securities, and asset-backed securities, and is commonly used to track the performance of U.S. investment-grade bonds.

The MSCI Emerging Markets Index tracks the performance of equity stocks in selected emerging foreign markets.

The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-value ratios and higher forecasted growth values.

The Russell 2000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell1000 companies with lower price-to-book ratios and lower expected growth values.

The S&P 500 index is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the U.S. stock market.

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