PACIFIC FUNDS

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ANALYZE THIS

A look into how five Covid-19-impacted sectors are performing more than one year into the pandemic—and what the future may hold.

We asked Pacific Asset Management, sub-advisor to Pacific Funds fixed-income funds, to analyze the gaming, healthcare, hotel/lodging, retail and technology sectors amid the vaccination rollout and economic rebound.

Healthcare: An improved prognosis

By Shalini Viswanathan, CFA

Director, Pacific Asset Management

The healthcare sector has been in many ways at the epicenter of the COVID-19 economic earthquake. In some areas such as emergency care, patient volumes exploded with rapid rises in COVID cases. However, much of the sector saw demand collapse as patients stayed home and avoided higher-risk environments.

Some liquidity relief was found through the CARES Act and other 2020 relief programs, but the recovery has been uneven. Many providers saw demand slowly pick up in the third quarter of 2020, only to diminish with the resurgence of the virus around the holidays. Hospitals in hotspot zones once again deferred non-essential procedures.

Providers did adapt in many ways to the new environment expanding services such as telehealth to attract patients. But in many cases, there was simply no good alternative to in-person services, and we expect that volumes will return to pre-COVID levels and beyond only in the latter half of 2021. Wide availability of vaccines should help accelerate that recovery and attract cautious patients who have been unwilling to enter healthcare environments. Providers are cautiously optimistic on their outlook for this year but are prepared for a possible resurgence of COVID and have the capacity (both beds and PPE) to handle that.

> Providers are cautiously optimistic on their outlook for this year but are prepared for a possible resurgence of COVID

Looking beyond the large healthcare providers, the outlook across other healthcare subsectors remains mixed. For example, large dialysis companies did not need to take advantage of the CARES Act for liquidity but faced increased mortality among patients due to co-morbidities. They have taken on additional costs and measures to ensure a safe environment for procedures but expect reduced volume to last through 2021. The outlook here remains steady.

Managed-care companies addressed the pandemic by offering COVID-related, cost-sharing waivers; more customer support; new, specialized services; and premium rebates. Increased unemployment changed the health insurers' enrollment mix, lowering commercial enrollment and increasing the number of people covered under government programs. The prolonged economic recovery will be a headwind. This year, managed-care companies will continue to see COVID-related costs, but they will not have as much of an offset from deferral of COVID treatments as they had in 2020. The Biden administration's increased support of Affordable Care Act (ACA) exchanges should boost overall enrollment and is also a positive for providers.

Companies in healthcare continue to focus on liquidity and balance sheet flexibility. Credit markets have remained open, allowing them to manage debt maturities and costs. At the same time, companies have also successfully streamlined expenses and margins. Providers who received Medicare advance payments will start repayment in April 2021. Overall, companies have adapted well to the changes driven by the pandemic and will now need to focus on reducing indebtedness on their balance sheets.

Technology: Not slowing yet

By Shalini Viswanathan, CFA

Director, Pacific Asset Management

The large increase in demand for technology in 2020 shows few signs of slowing so far in 2021. Demand is strengthening in several technology end markets, including autos, industrial, hyperscale, 5G and PCs.

Cloud software and infrastructure growth companies continue to benefit from the work-from-home trend, with elevated demand for streaming, data centers, server CPUs, and PCs and notebooks. Some portion of the work-from-home shift and related demand is expected to be permanent. Cloud growth, improving mobile phone technology (successful rollout of Apple's 5G phones), and improving demand for memory products are all likely to be tailwinds well into 2021.

Software companies have been largely resilient to COVID disruption. They are, however, seeing that demand for in-person meetings is still low. They continue to see some delays in decision-making and are adjusting their marketing strategies around that. Enterprise demand (IT spend) remains constrained but is expected to improve later in the year due to pent-up demand. Long-term pressures in PCs and printers/copiers will remain.

> Generally, we are hearing a cautiously optimistic tone from companies.

In the semiconductor space, companies that were well positioned in 2020 were those with diversified end markets and exposure to smartphones, PCs, gaming consoles, consumer electronics and enterprise hardware products. Due to the pandemic, auto production shut down in March 2020 and resulted in sharp decline in orders and production of semiconductor chips. We saw a meaningful recovery in autos in the fourth quarter of 2020, and that trend continues into 2021. This should benefit semiconductors companies exposed to autos, including NXPI, Sensata, MicroChip and Texas Instruments.

However, these companies faced a global-supply squeeze caused by new U.S. Commerce Department regulations effective September 2020 that restricts the export of various semis equipment/components to certain Chinese firms. The U.S. companies are working past these headwinds by dynamically adjusting pricing, inventory and vendor programs to meet demand, and prioritizing certain products and segments. Supply shortages are a short-term headwind but expected to improve by the second half of 2021.

Technology is not a homogenous space, and earnings estimates vary due to many reasons, including end-market exposures. Generally, we are hearing a cautiously optimistic tone from companies. Many technology companies continued with shareholder returns through dividends and share buybacks in 2020. They still have adequate financial flexibility/liquidity and balance-sheet capacity. Credit markets are open and supportive. We expect to see ongoing mergers and acquisitions in semis, payment tech and software spaces due to the importance of being an integrated solutions provider and benefits of scale.

Hotel and Lodging: On the road again

By Michael Long

Managing Director, Pacific Asset Management

2020 was the most challenging year ever for the hotel industry. Declining occupancy rates, employee furloughs, and almost no business travel pressured the sector in ways never experienced. But recovery is underway, driven by leisure travel. Continued success of the vaccine program is key to both business and group-travel recovery. COVID-related impacts will continue to pressure companies in the first half of 2021, but we are seeing green shoots of recovery.

Globally, the recovery varies by region, with China continuing to lead, the U.S. gradually improving, and Europe lagging. In the U.S., net bookings have steadily increased since the start of 2021, and occupancy rates industrywide show signs of rebounding as consumers gain the confidence to take trips. Drive-to, resort markets and lower-priced offerings are outperforming, while urban and upper-scale segments are underperforming. The extended-stay segment is performing well, as it has throughout the pandemic. Brands are taking share from independents and earning higher margins. Also, loyalty programs have become more important, benefitting companies such as Hilton Hotels & Resorts, Hyatt Hotels Corp. and Marriott International.

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Business demand remains quiet but showed some modest signs of improvement in the first quarter of 2021. Businesses have been more cautious than consumers in the speed of return to traveling, but we should start to see meaningful improvement in late 2021, possibly reaching pre-COVID run rates in 2022. A yet-to-be-determined downside is the longer-term impact from greater use of video conferencing as a replacement for business travel. In our view, some long-term impact is likely, but in-person meetings remain a powerful business tool and will likely continue to drive business in the years to come. Group demand should be the last to return with most group business expected to return in 2022/2023.

The outlook for timeshare operators such as Marriott Vacations, Wyndham and Hilton Grand Vacations is positive due to their leisure travel focus, diversified business model and strong brands. An improved COVID environment will allow these companies to reignite sales and launch expansion projects later this year and next. In a year when “experiences” lost out to “nesting,” the timeshare sector’s locked-in client base again proved the resiliency of the business model.

From a market perspective, these positive sector trends are already well reflected in both bond and equity prices, which have rallied significantly on improved expectations. Going forward, picking the outperformers will become much more critical instead of making broad industry bets.

Gaming: Improving odds

By Michael Long

Managing Director, Pacific Asset Management

The outlook for gaming operators is positive with regional U.S. casinos expected to outperform in the first half of 2021, followed by Las Vegas in the second half. Saving rates have been high, and consumers are ready to spend on experiences they have largely avoided in 2020. A rise in new COVID-19 cases that could drive reduced capacity remain a risk, but we see low likelihood of that occurring in most markets.

Regional casinos have rebounded since re-openings started in May 2020. Regional gaming markets are recovering faster than Las Vegas as they benefit from customers staying closer to home and having limited entertainment and travel options. Pent-up demand, a younger demographic, and the impact from stimulus money are driving momentum in 2021. Regional operators such as Boyd Gaming, Caesars Entertainment and Churchill Downs are performing well.

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Las Vegas continues to lag regional markets due to its reliance on air traffic and convention business. A larger percentage of Vegas casino profitability comes from non-gaming profit centers such as restaurants and entertainment, which will be slow to return. As vaccines become widely distributed and consumers become more comfortable getting on planes and gambling indoors, expect a slow sequential improvement in the first half of 2021 that should accelerate through the end of the year. In the fall, we could see a nice recovery with airline and convention activity picking up.

Most gaming operators have solid liquidity and have been successful at cutting expenses and improving profit margins. The vast majority of those margin gains are expected to be sustainable as the industry returns to 2019 levels. If that turns out to be true, the gaming industry could be far more profitable long-term than we have seen in the past. But we'll see.

Sports betting and online gaming (igaming) took off in 2020 and are expected to grow further in 2021 and beyond. Also, look for more states to approve gaming and sports betting this year to help balance difficult state budget shortfalls.

Retail: What people are buying

By Ron Rangel, CFA

Analyst, Pacific Asset Management

2020 was a year of bifurcation and acceleration in retail; while some companies thrived during the pandemic, others were forced to restructure or liquidate (though many had already been struggling). The wallet-share dispersion in 2020 was unprecedented as certain categories, namely mass market, home, auto, arts/crafts, sporting goods, pets, electronics, and loungewear/active, saw massive tailwinds as dollars shifted away from department stores, fashion apparel, and off-price. Services were also a loser in a "nesting" year as COVID-cautious consumers saved money on travel, restaurants, entertainment, etc.

One major effect of the pandemic was the rapid rollout of alternative-fulfillment channels such as buy-online-pickup-in-store, curbside pickup, and ship-from-store delivery. Retailers that had tested these omnichannel offerings pre-pandemic were rewarded as the initiatives proved quite successful. In a post-lockdown world, can these alternative-fulfillment options can give brick-and-mortar retailers a material defense against the pure-play "e-tailers" that have been crushing the retail sector for years? I personally believe these initiatives have helped transform some store bases from liabilities into assets given quicker fulfillment times and solid margin profiles, but uncertainty remains.

> It is important to look past near-term noise and seek retailers that have winning businesses over the long run.

Looking ahead, it is difficult to be fundamentally pessimistic on retail in the near term given the massive fiscal stimulus over the past 12 months (more than $5 trillion vs. less than $1 trillion during the 2008-09 Financial Crisis). M2 money supply is up more than 25%, and there is an incremental $2 trillion or so in consumer savings compared to pre-COVID levels (to give some context, $2 trillion is about 10% of GDP!). This also comes as a time when the employment numbers are improving, and vaccine rollouts are (hopefully) leading to permanent re-openings.

With that said, investors are concerned with certain companies lapping strong results last year, the potential for wage and tax hikes, cost inflation, wallet-share shifts back to experiences, etc. I'd also mention that investors understand the strong fundamental backdrop and sentiment reflects it. Given the near-term fluidity, I continue to believe it is important to look past near-term noise and seek retailers that have winning businesses over the long run. Retail is a very competitive industry and, as history has demonstrated, not every company stays in style.

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M2 money supply is a measure of the money supply that includes cash, checking deposits, and easily convertible near money.

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