PACIFIC FUNDS insights

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INFLATED CONCERNS

With the consumer bump still ahead, is there too much money chasing too few goods?

On June 15, we sat down with Dominic Nolan, senior managing director of Pacific Asset Management, to get his insights on the market's performance in May, the specter of rising inflation, the firmness of the Fed's stance and more.

Equities and bonds finished slightly higher for May, but it was a mixed picture as the market grappled with reopening bottlenecks. Can you give us a sense as to how the month played out?

Across the board, it was pretty flat. I'll start with the S&P 500 Index for May. It was up less than 1%, but for the three-month period was up 10.7%, and year-to-date up 12.5%. Russell 2000 Value Index continued to lead. We did have a reversion in April, but through May, Russell 2000 Value was up 3%, whereas the Russell 1000 Growth Index was negative. The three-month numbers for the Russell 2000 Value were up almost 11%, while the Russell 1000 Growth was up 7%. Year-to-date, Russell 2000 Value was up 27%, while Russell 1000 Growth was up 6%.

Russell 2000 Value continues to be the standout story, although when you look over three months, it's in line with the S&P. Leadership really came from the large-value companies. I think, in particular, financials have done very well. Interesting dynamic in May: the MSCI EAFE Index was up 3.5% and was performing in line with the S&P, up about 9% over the past three months. We'll be curious to see if the international markets are going to be able to make up some of the ground that they lost compared to the U.S. market last year.

What about fixed income?

The Bloomberg Barclays US Aggregate Bond Index was up 33 basis points, which was above coupon. So, you did have rates settle in a little bit. The three-month numbers were up about 1%, but year-to-date was still down 2%. In leveraged finance, Bloomberg Barclays US High Yield index was up 30 basis points, in line with the aggregate index, up 1% over three months, and still up 2% for the year. The leader was still floating-rate loans, up 50 basis points for the month, 1% over three months and up over 3% for the year. Floating rate continued its momentum in May, up about 500 basis points relative to the general aggregate index. The floating over fixed trade has been, I think, a good trade so far this year.

The Federal Reserve (Fed) recently announced that its selling corporate bonds and ETFs as required by the establishment of last year's emergency Secondary Market Corporate Credit Facility. How do you see this impacting markets?

This was an interesting move in that it did take the market by surprise when the Fed announced it will begin selling the bonds they purchased last year through the credit facility and should be finished by the end of this year.

When you look through the actual volumes, it is not impactful. The facility has about $14 billion in bonds and ETFs—approximately $8.5 billion in ETFs and $5 billion in bonds. Now that is a small amount when you compare it to $46 billion in inflows that we've seen into high-grade funds.

If you really think about the Fed as being a reinsurer, then essentially your reinsurance is going away. In theory, I wouldn't be surprised if we had marginally higher spreads.

Why? Because in theory, the risk of corporate bonds has increased on the margin without the Fed facilities there. But again, it probably has a de minimis effect. The real test is intermediate-term. I bring it up because when you think about the impact of the Fed, it was really signaling, which was in March 2020. They didn't buy until summer. Now they're signaling that they're stepping away. The reason is because they feel the market doesn't need it, which many would concur and the data would show. There's now plenty of liquidity and demand for corporate bonds.

There are still some questions: Is this a signal that we should expect that the Fed is going to tighten more quickly? This surprise to the market on the corporate credit facility, does that lead to a quicker quantitative easing (QE) tapering and eventually lead to an acceleration of increased short-term rates? That, to me, is the more interesting element, but we won't know the answers for a few months. Just be on the lookout for that.

Let's turn to inflation, the topic du jour. We see signs that inflation is up, and then it may moderate a little bit, or at least expectations are that way. How do we see inflation playing out?

That is really the big topic for 2021, and I'll start with U.S. dollar inflation swaps. What's the market saying when you look through the derivatives, which is a very large market? The one-year inflation swap is expecting an elevated inflation rate of around 3.5% to 4%. However, this drops dramatically over the next two to three years to the 2% to 2.5% range. There is certainly an expectation that inflation is going to be higher this year and maybe next year, but the expectation is more for transitory inflation.

With $5 trillion in stimulus over the past year and a high level of consumer savings, the demand side of the equation has been set up, and now the supply side of the equation needs to catch up. You have supply bottlenecks, capacity constraints, material shortages, weather issues, logistic issues, and employment issues, among other challenges. All of that is distorting supply, and so when you have that imbalance, you're essentially seeing what we're seeing on the inflation front.

So, looking in the derivatives market, there's not much indication that this is anything more than transitory. Correct?

Absolutely. By the way, "transitory" is an ambiguous word. Is transitory one year or five years? I think certainly this year, you'll have elevated inflation and probably next year. Longer-term, I believe there are many disinflationary elements. For example, what about labor? If a company has 100 employees working remotely during the pandemic, when they return to the office, companies may realize that they don't need 100. Maybe you only need 90, or fewer. Assuming work-from-home and technology increases productivity, more so than sustainable demand, it should eventually lead to lower costs. I don't know if the job market gets back to the same absolute numbers as it did before, which is technically disinflationary. I just think there are a lot of inflationary pressures today. What will those inflationary pressures look like in two to three years? I think they're going to drop off significantly. I personally believe this is transitory in nature.

Can you put numbers to where we are in the economic rebound?

Let's look at the Institute of Supply Management (ISM) report that recently came out. The business reading was 64. Typically, anything above 50 is expansionary. You can see that 64 is a really high number. That number comprises four equally weighted components. One is business services, and that's a very robust 66. New orders came in at a 64—again, really robust. Supplier delivery or logistics was a 70—very robust. All those elements are signaling huge expansion. The fourth component, the employment index, was lower, and it dropped to 55. Now that's still growth oriented, but you're having issues around employment such as finding enough labor, which is a combination of government programs and a more open economy, businesses that need to staff up, seasonality, etc.

There's a lot of distortions impacting inflation. In the second quarter of this year, inflation could come in at 3 to 4%. But you also have to look at the GDP. The Atlanta Fed offers one of the few real-time GDP forecasts. It estimates real GDP for the second quarter at 10.3% (as of June 1). You add both together, GDP and inflation,

you could have nominal GDP growth of 13 to 14% in second quarter.

That's staggering. We came out of a decade where GDP sat at 2%, and we hadn't hit 3%. Now nominal GDP now could be in the teens. That's amazing, in my opinion. The question is how long will this inflation crunch last? We know it's going to be here this year. We threw a lot of checks in the marketplace, and many people aren't back to work yet. Those things have to be normalized before we get a sense of what inflation looks like.

One other place that we see signs of inflationary pressures is through sectors. What can you tell us about how sectors of the economy are faring?

In a nutshell, the economy is ripping. Let's look at the Bank of America daily credit-card spending report. This is through May 29. Total credit-card spending year-over-year is up 34%, but that's to be expected because we were in a COVID economy last year. But compared to two years ago, spending's still up 20%, and many felt the economy was very robust in 2019.

Sectors of note: Airlines were down 10% over 2019. On the surface, that's not a compelling number, but just back in February, they were down 75%. That's a quick acceleration in the travel sector. Restaurants were up 104% year-over-year. Again, that's to be expected since it's measured against the pandemic shutdown. Compared to two years ago, restaurants are still up 18%. Relative to two years ago, home improvement is up 43%. That's a massive number, but again, consistent with the hot housing market we're in.

I guess this isn't surprising to anyone who's recently tried to buy a car, but a recent ISI survey revealed that in more normal times, about 10 to 20% of auto dealers say their inventory is too high. Now, 70% of the dealers said their inventory was too low. Cars are in high demand, and I think that's a byproduct of the work-from-home trend, the millennial household formation and the microchip shortage. You have some confluence of factors that are leading to this. Not surprisingly, demand for used cars is at all-time highs.

This "inflation pricing power" is firmly in the hands of the supply side. The passthrough is going through, not only the passthrough in absolute, but the passthrough in margins. It's one thing if you have a dollar increase in cost, and you pass on a dollar to the client. Now, you have a dollar increase in costs. You can pass on multiples of that to the client and probably increase margins right now. Inflation is going straight through to consumer.

So, if companies are increasing their margins as well, the consumer is bearing even more than just the rise in inflation?

Right.

Any surprises?

Online retail was a little interesting if you assumed COVID was a huge digital accelerant. For one year, retail's up 4%. Over two years, it's up 86%. That's almost a doubling of online retail spend versus two years ago.

Where in the U.S. is the economy generally doing better?

The cities that seem to be doing the best versus two years ago are Phoenix, Atlanta, and Miami, which are all in southern states. Then you have Detroit and Chicago in the Midwest, and I don't know if that's an anomaly, but maybe they're just opening and having that spend. But you definitely see the cities in the southern half of the United States performing well versus two years ago.

Do you think the Fed begins to taper prior to yearend?

I think if the Fed hadn't already come out this year and said they would wait, I would say, "Yes," but I'm going to say, "No," just because they had indicated they would wait.

On balance, the Fed still seems bullish and willing to adjust. Do you think they are going to change their tune anytime soon?

No, they have plenty of defenses as to why they should sit tight, with the anchor being transitory inflation.

With the economic bounce we've seen and with rates still low relative to inflation expectations, how do you see opportunities in fixed income evolving at this point?

I'll highlight the big themes. The fundamentals are strong. While supply constraints are hampering sales, inflation elements are being pushed through to the end client. Default rates in high yield and loans over the next year are projected to be less than 2%. So, corporate debt has a nice backdrop. While winding down the Secondary Market Corporate Credit Facility is less accommodative, the Fed is still accommodative and on the side of risk assets. What's going against risk assets is relative value, but in corporate bonds, the higher interest helps the waiting game.

With the Fed marginally reducing accommodation, you could have some modest spread widening, but right now, the story is inflation. Why step into fixed rate when the fundamentals are strong and the Fed's still anchoring the low end? Reduce volatility by anchoring short duration and holding spread assets as long as the economy is strong. That's essentially the same narrative we had back in January, and, to some extent, the trade has run, but the overlying or macro backdrop hasn't changed.

So more of the same, still favoring the floating rate over the more fixed-rate assets.

I would add a caveat though. If rates go up another leg on the long end, then I think adding duration actually might be a decent trade.

Care to say what another leg would be?

In the high ones or low twos on the 10-year Treasury.

It's that time again for your non-economic thought.

I have a high school senior, and he's about to go through his graduation ceremony. So, I'll share with you what I thought was a very good—and a bit nontraditional—commencement speech from 2017. It was given by Supreme Court Chief Justice John Roberts at Cardigan Mountain School, a boarding school in New Hampshire for boys in grades six through nine.

"From time to time in the years to come," he said, "I hope you'll be treated unfairly so that you will come to know the value of justice. I hope you will suffer betrayal because that will teach you the importance of loyalty.

"I wish you bad luck from time to time so that you'll be conscious of the role of chance and understand your success is not completely deserved, and the failure of others is not completely deserved either. I hope you'll be ignored so you know the importance of listening, and I hope you will have just enough pain to learn compassion."

For graduating kids like my son, they'd be served well to remember that struggle is growth and perspective.

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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 EAFE Index** is designed to measure the equity-market performance of developed markets in Europe, Australasia, and the Far East.

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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