PACIFIC FUNDS insights

JULY 2021

WILL 2021's STRONG FIRST HALF CONTINUE?

2021's first half gave us vaccinations, an economic rebound and rising inflation. What's next?

On July 19, we sat down with Dominic Nolan, chief executive officer of Pacific Asset Management, to get his insights on the market's performance in June, the Federal Reserve, Treasury rates, and the economy.

How did markets do in June?

We had a pretty strong month in June. I'll start with the S&P 500 Index, which was up a little over 2%. For the quarter, it was up about 8% and 15% for the year. It was a very strong equity market in the first half of 2021. Let's look at the Russell 1000 Growth Index versus the Russell 2000 Value Index. For most of 2020, technology and digital (which are reflected in the Russell 1000 Growth) were winning. But with the launch of the vaccines, it shifted to more traditional businesses (represented by the Russell 2000 Value) that had been depressed throughout the 2020 rally.

What about fixed income?

In June, the Bloomberg Barclays US Aggregate Bond Index was up 70 basis points, which was above coupon. For the past three months, it was up about 180 basis points, but for the year it was still down 1.5%. When you think about a balanced portfolio—say split evenly between the S&P 500 and 50% in the bond index—you would be coming in around 7 to 8% for the year. On the credit side, high yield did well in June, up 1.3%, benefiting from lower rates. For the past three months, high yield was up 2.75% and over 3.5% for the year.

Floating-rate loans were really steady, up 41 basis points for June. For three months, it was up 1.5% and 3.5% for the year. So high-yield and floating-rate loans were both up 3.5% for the year, continuing to outperform the aggregate index by almost 500 basis points.

For 2021, I think it's been a quite constructive first six months all round.

June marked a turning point in expectations for growth and inflation. What has been the Federal Reserve's response?

Well, there's a push and pull, right? If the Fed believes they're going to tap the brakes or let up on the gas earlier, we know that's due to a robust economy and inflation. However, that also tightens financial conditions, so that tends to be restrictive. If you look at the June 16 meeting, the Fed essentially shifted forward expectations for a rise in interest rates. Right now, seven of the officials see a rate raise in 2022, but back in March, that number was only four.

Also, keep in mind what Powell said: the Fed is going to talk about talking about tapering. He's just setting up the talk to announce that they're probably going to begin tapering. But remember, the front end is still anchored, and quantitative easing (QE) is still in place.

The Fed's narrative appears to continue to be: first, we're winding down the credit facilities, now we might be looking to taper, and then a rate rise. I think the Fed continues to be very transparent. They're trying to give the market the heads-up about what's coming, including that they believe the rise in inflation will be transitory.

What about the 10-year Treasury? It opened the year at 93 basis points and is now up 145 basis points. What's behind that?

Yields are up about 50 basis points for the year, but what has happened over the past month is that inflation expectations are down about 25 basis points. And that certainly factors in. When you go to restaurants, grocery stores, gas stations, etc., you certainly can see firsthand the rise in inflation. But the bond market projects out much further and looks at whether the inflation is structural in nature. One factor is that future inflation expectations are down. Two, the consensus among investors in the street was that rates must go up. So, in theory, you have a crowded trade. Three, the Fed is still buying $120 billion a month of bonds. And then four, and this is a newer dynamic, the delta variant of COVID-19 has been rapidly spreading. While we aren't seeing significant impacts here in the United States, it is affecting global economies, and they're still wrestling with it. When you have much of the world wrestling with the delta variants, that constrains supply chains, which, in turn, affects company spending and profits.

So essentially, those are reasons behind why you have rates moving lower—some are fundamental reasons and others are technical reasons.

What does sector data tell you?

I'll use the daily credit card data from Bank of America as an anchor for this. What's clear is that the consumers are shifting their spend. For example, furniture spending has contracted for over three straight months, even in this hot housing market. It appears that instead of buying something for the house, consumers are spending on travel, which is why airlines and lodging were up very strongly in June.

Now, if you look at spending versus two years ago, where do we sit across sectors? Groceries were up 9% versus two years ago. That to me is inflation playing a large role. Gas was up 10%. Again, inflation is a big part of that. Restaurants were up 15%. Despite a recent contraction in spending, furniture was still up 34% versus two years ago, consistent with a strong housing and home improvement market. Airlines were down 14% over two years ago, owing mostly to the fact that business travel isn't near pre-pandemic levels. But considering that airlines were down over 70% just a few months ago, I think is a significant recovery. Department stores were down 4% versus two years ago, which I think is a decline that's more secular in nature.

Where does this leave us in terms of opportunities in fixed income?

I think supply chains will start to normalize over the next three to six months, and the economy should stay strong. For fixed income, I believe that it means rates on the long end will continue to be volatile. Duration can be a friend if rates start to move up. But in the meantime, your defensive yield sits in loans, which again is up 3.5% for the year. That's actually a great yield when you have negative yields outside of the United States and a 1.3% U.S. 10-year Treasury. When you have a strong economy and default rates expected to be low, that's still a nice place to be.

Can you give insight into the buyers of low-yield 10-year Treasuries?

For retail investors, the U.S. government is saying, "I will pay you 1.3% nominal over the next 10 years." But when you factor in inflation at 2 or 3%, why in the world would you buy it?

That's an individual investor's reasoning, but central banks don't buy Treasuries for that reason. Large sovereign wealth funds don't buy it for that reason. Banks hold it for regulatory reasons. Insurance companies may hold it for liability reasons. Corporate pension plans hold it for immunization of liabilities. And those are massive pools of money. Now factor in European and Japanese investors who are staring down the barrel at sub-25-basis-point government bonds, they'll take our Treasuries all day. So really, when you think about those large pools of money, retail investors are outmatched. As a result, you have a negative real yield. As long as that's in play, expect Treasuries will continue to have a negative real yield.

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

I've always loved Independence Day. I wasn't born in this country, but the foundation of many of the blessings that I have are due to this country. This year, it prompted a thought: our family should do something extra for the country, but I didn't know exactly what that might look like. It might mean turning off the news and volunteering for a community project. So, all the kids are helping at a local camp this week.

The Fourth of July is a perfect time to reflect on how we all can serve the kids, the community and country. The holiday was a reminder to me that our family has a lot to be thankful for due to this country.

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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 **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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Mailing address:
P.O. Box 9768, Providence, RI 02940-9768
(800) 722-2333 • www.PacificFunds.com

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