PACIFIC FUNDS insights

NOVEMBER 2021

HOW WILL THE YEAR END?

That depends on several factors, including supply chains, COVID, and Big Tech regulation. But in the end, we believe value and small-cap stocks may come out winners.

By Samuel Park, Director of Fundamental Research, Pacific Life Fund Advisors

Market Review

In the third quarter of 2021, large-cap growth stocks continued their upward momentum. Falling interest rates helped the interest-rate-sensitive stocks, while the flattening yield curve dragged the financial sector. Emerging markets suffered from its exposure to Chinese stocks, which have been battered by the Evergrande debt crisis. Investors had compared Evergrande's situation to the Lehman Brothers fallout, which heightened concerns of contagion.

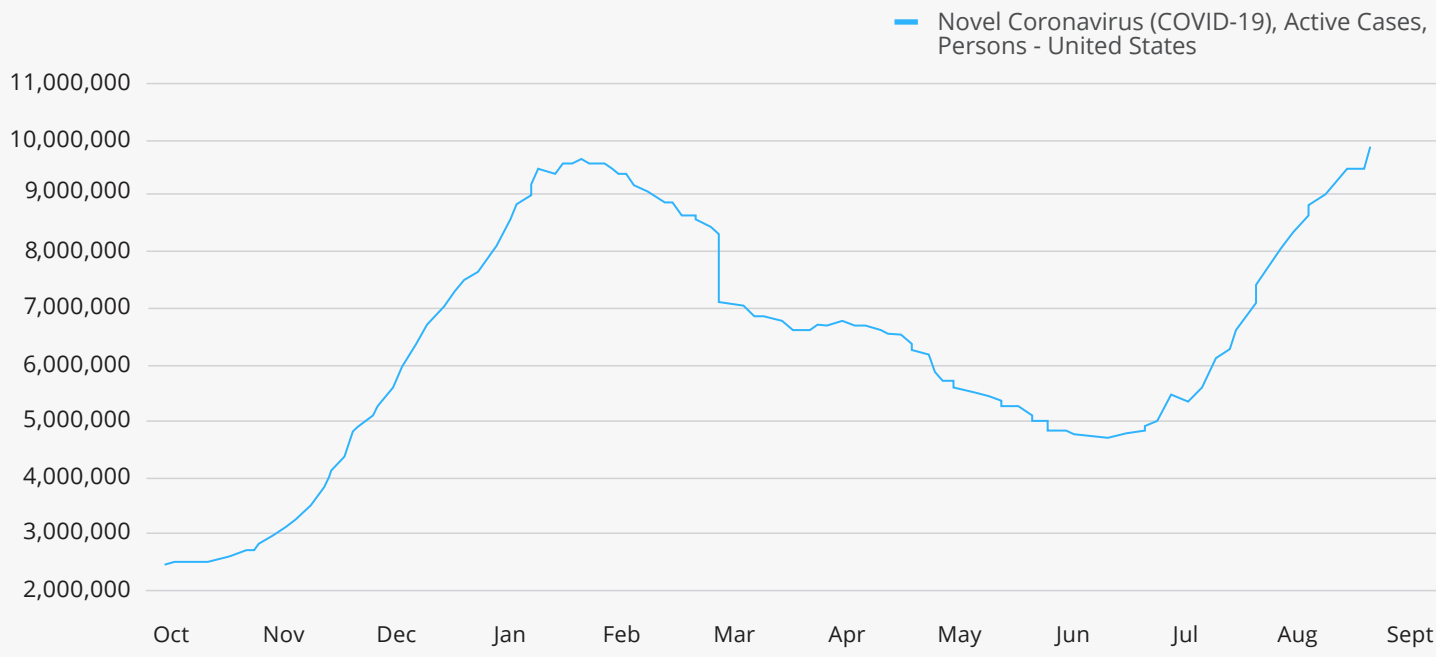
Within fixed income, higher inflation expectations amid still-ample monetary support continued to push Treasury Inflation-Protection Securities (TIPS) and high yield to outperform the broader Bloomberg Barclays US Aggregate Bond Index. On the other hand, with the Federal Reserve keeping the fed funds rate anchored, short-term bonds lagged the broader fixed-income market.

Outlook

As we head into the final quarter, there are several items up in the air. The Fed has held steady with its interest-rate policies despite the pickup in inflation, suggesting supply-chain disruptions were causing a transient rise in inflation. Much of this supply-chain disruption is caused by semiconductor-chip shortages.

This shortage in chips has continued for more than a year and is not expected to be resolved soon. The auto industry has had to deal with temporary shutdowns and, as a result, is producing much fewer vehicles. Chip supply was expected to bottom out earlier in the year; however, a recent surge in COVID-19 cases caused a new round of plant closures that halted chip production in countries such as Malaysia.

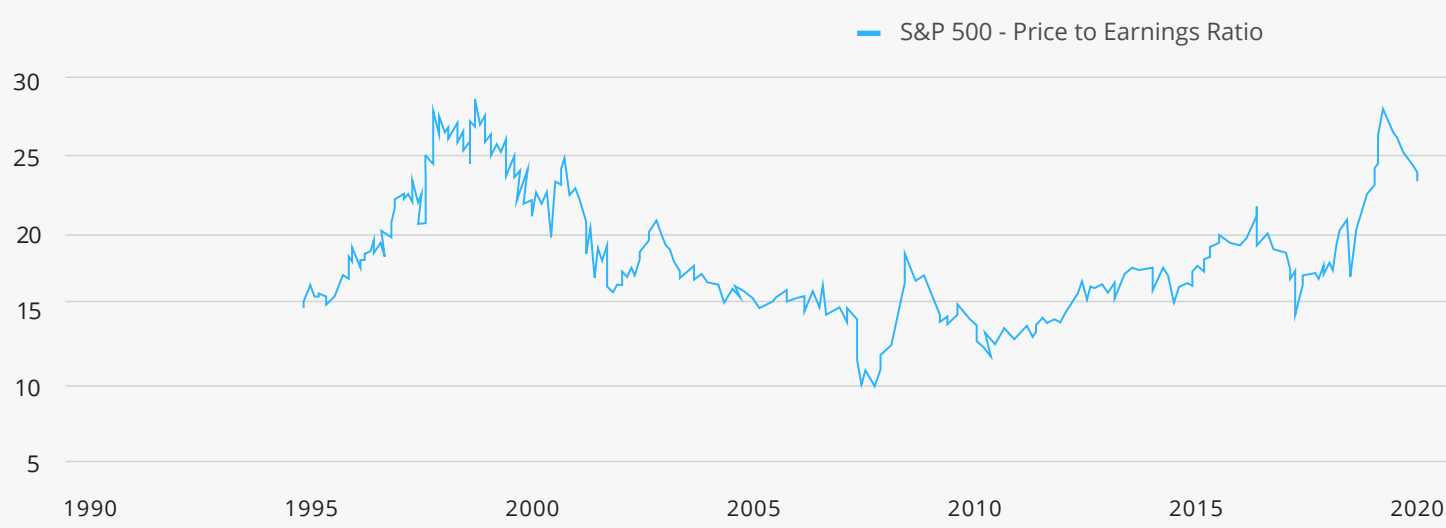
While vaccine progress continues among Americans, the Delta variant has caused active cases to surge once again in recent months, including in the U.S.



Source: FactSet as of 9/28/21

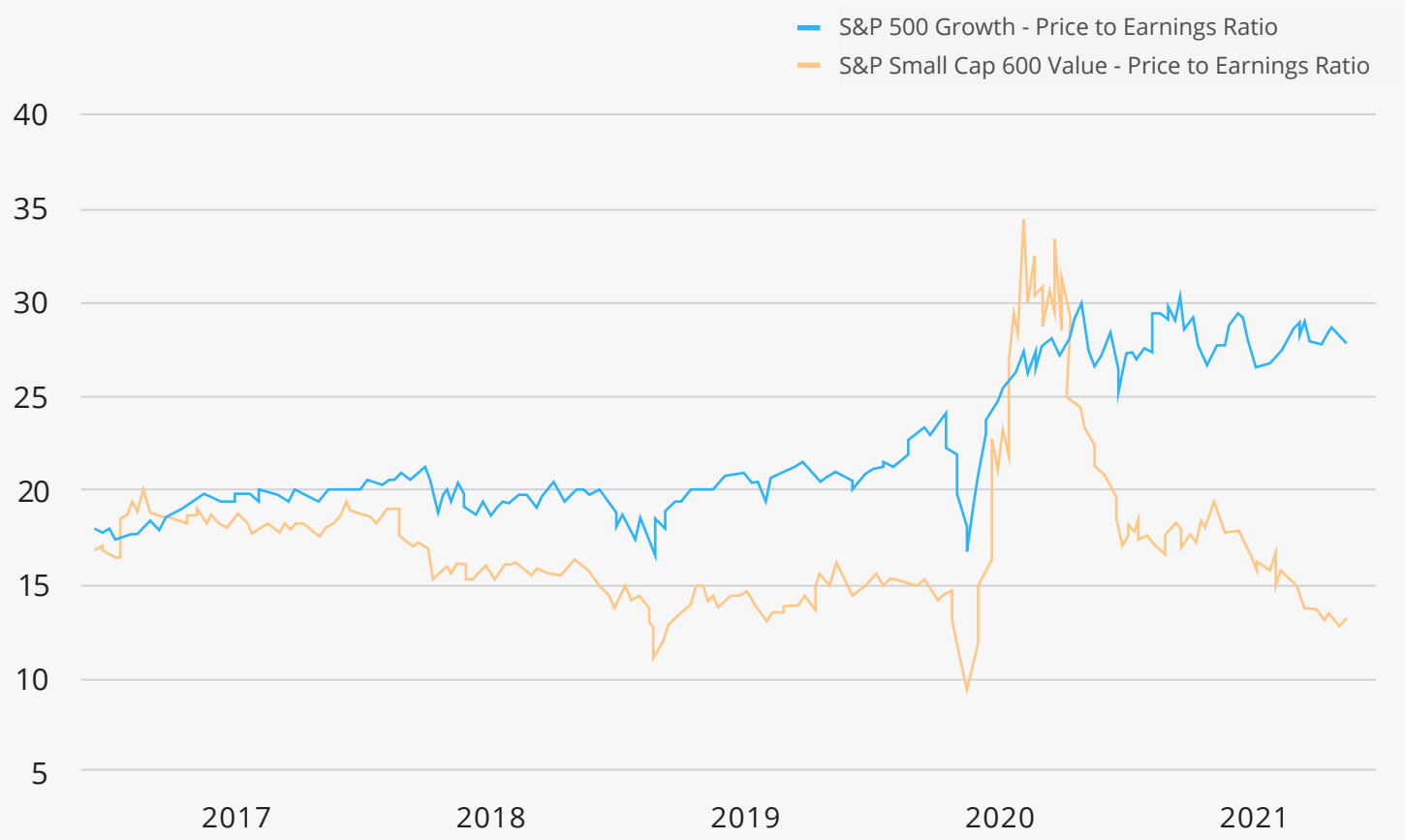
Once again, investors rotated into Big Tech names. The lack of strong growth for traditional businesses and U.S. households now dealing with the Delta variant has favored a few dominant companies and sectors such as U.S. large-cap growth stocks, leading to extremely high valuations for many of the tech giants.

The following chart shows that price-to-earnings of the S&P 500 Index reached its peak near the end the 2020 before falling off.



Source: FactSet as of 9/29/21

However, by separating the index into value and growth as well as size, we can see how expensive large-cap growth is relative to its small-cap value counterpart.It should be noted that U.S. Big Tech names are represented in the large-cap growth indices, while smaller financial companies make up a bulk of small-cap indices. The following chart illustrates that it's mainly large-cap growth stocks that maintain elevated price-to-earnings ratios, indicating the frothiness of U.S. Big Tech names. On the other hand, small-cap value now trades at attractive levels.



Source: FactSet as of 9/29/21

Another large headwind for many financial institutions was the low interest rates that have hurt their profitability. Although the Fed anticipates keeping interest rates low through 2022, price multiples on many of these smaller regional banks appear to be considerably more attractive compared to their larger growth-focused counterparts. This is particularly true as politicians have increased scrutiny over the tech giants and begun to show more empathy toward smaller companies.

The Fed is likely to stick close to its plans related to interest rates and the tapering of its $120 billion per month asset-purchase plan. As the Fed slows its Treasury buying, the yield curve may begin to steepen, which should be a tailwind for financials.

While the reflation trade took a breather, we believe both value and small caps look attractive and could come back in favor.

Definitions

The **Bloomberg Barclays U.S. Aggregate Bond Index** is composed of investment-grade U.S. government and 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 **price-to-earnings (P/E) ratio** relates a company's share price to its earnings per share.

The **S&P 500 Growth Index** identifies growth stocks using three factors, sales growth, the ratio of earnings change to price, and momentum.

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.

The **S&P Small Cap 600 Value Index** is a stock market index established by Standard & Poor's. It covers roughly the small-cap range of American stocks, using a capitalization-weighted index.

Treasury Inflation-Protected Securities (TIPS) are a type of Treasury security issued by the U.S. government. TIPS are indexed to inflation in order to protect investors from a decline in the purchasing power of their money.

For more insights from Pacific Funds, visit

PacificFunds.com

About Principal Risks: There is no guarantee the Fund will achieve its investment goal. Asset allocation and diversification do not guarantee future results, ensure a profit or protect against loss. Although diversification among asset classes can help reduce volatility over the long term, this assumes that asset classes do not move in tandem and that positive returns in one or more asset classes will help offset negative returns in other asset classes. There is a risk that you could achieve better returns by investing in an individual fund or multiple funds representing a single asset class rather than using asset allocation. A fund-of-funds does not guarantee gains, may incur losses and/or experience volatility, particularly during periods of broad market declines, and is subject to its own expenses along with the expenses of the underlying funds. It is typically exposed to the same risks as the underlying funds in which it invests in proportion to their allocations.

This commentary represents the views of the portfolio managers at Pacific Life Fund Advisors LLC as of 9/30/21 and are presented for informational purposes only. These views should not be construed as investment advice, an endorsement of any security, mutual fund, sector or index, or to predict performance of any investment. Any forward-looking statements are not guaranteed. All material is compiled from sources believed to be reliable, but accuracy cannot be guaranteed. The opinions expressed herein are subject to change without notice as market and other conditions warrant. Sector names in this commentary are provided by the Fund's portfolio managers and could be different if provided by a third party.

Pacific Life Insurance Company is the administrator for Pacific Funds. It is not a fiduciary and therefore does not give advice or make recommendations regarding insurance or investment products.

You should consider a fund's investment goal, risks, charges and expenses carefully before investing. The prospectus and/or the applicable summary prospectus contain this and other information about the Fund and are available from your financial advisor or PacificFunds.com. The prospectus and/or summary prospectus should be read carefully before investing.

Pacific Funds are distributed by Pacific Select Distributors, LLC (member FINRA & SIPC), a subsidiary of Pacific Life Insurance Company (Newport Beach, CA), and are available through licensed third parties. Pacific Funds refers to Pacific Funds Series Trust.

PF-20211109-0292

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

PACIFIC FUNDS