

MARKET REVIEW AND OUTLOOK

2nd Quarter 2020



Max Gokhman, CFA

Assistant Vice President, Head of Asset Allocation
Pacific Life Fund Advisors

Market Review

Global markets steadily recovered during the second quarter of 2020, although institutional investors generally remained on the sidelines, keeping their dry powder in money-market funds. Given the number of global events unfolding simultaneously, continually reassessing economic conditions has become more critical than ever. Global central bankers and legislators have unleashed enormous monetary and fiscal stimulus packages at an unprecedented pace, propelling risk assets upward. Whether these grand actions will be sufficient and, if not, how much additional stimulus will be needed remains an open question.

Interest rates remained at historically low levels as the Federal Reserve (Fed) resorted to extraordinary measures to keep the U.S. economy afloat amid the global pandemic. The Fed's willingness to provide a financial backstop likely prevented a liquidity crunch that would have sent the global economy into a tailspin. Investors unleashed a big sigh of relief by loading up on risk during the quarter. This kept the bond market (as defined by the Bloomberg Barclays U.S. Aggregate Bond Index) relatively stable with a modest gain of 2.9% for the second quarter, although it accumulated a gain of 8.7% for the trailing 12-month period (as of June 30, 2020). Both U.S. high-yield and emerging-market bond indexes surged during the second quarter while remaining relatively flat for the trailing 12-month period.

Equities remained modestly volatile but also buoyant as a flood of new retail investment accounts were opened after Congress decided to inject trillions of dollars of stimulus money into the U.S. economy. U.S. equities (as represented by the S&P 500 index) jumped 20.5% during the second quarter, recovering most of the losses from the prior quarter. Growth stocks, led by technology companies that have prospered in the new COVID-19 quarantined world, regained their momentum after briefly falling behind value stocks. The hope of the value rotation remained insufficient to support the brief reversal, as growth stocks quickly recovered losses from the first quarter. Small-capitalization stocks also benefited from positive investor sentiment as markets may be betting that the U.S. economy may avoid a deep systemic downfall, even as the National Bureau of Economic Research officially declared that the U.S. entered a recession in February 2020.

Foreign countries continued to struggle with the economic devastation caused by the coronavirus. While international equities also recovered during the second quarter, they continued to trail U.S. stocks. Nonetheless, emerging-market equities fared better than their non-U.S. developed counterparts. The MSCI EAFE Index and the MSCI Emerging-Markets Index had double-digit gains (14.9% and 18.1%, respectively) for the second quarter, although both remained in negative territory for the trailing 12-month period.

Performance data quoted represents past performance, which does not guarantee future results.

Insurance products are issued by Pacific Life Insurance Company in all states except New York and in New York by Pacific Life & Annuity Company. Product availability and features may vary by state.

Outlook

With unprecedented efforts and investment, the world will eventually conquer COVID-19, but some of the changes it brought will remain. Consumption represents nearly 70% of the U.S. gross domestic product, which suggest American household-spending patterns will shape how the economy recovers from the recession. Clear winners and losers will emerge from these developing trends, as workers upgrade their tech hardware at home and consumers accelerate their shift to online purchases as opposed to dealing with crowds at discount stores.

While domestic consumption greatly impacts the U.S. economy, international trade dynamics are changing. With globalization, countries operated more efficiently by focusing on their competitive advantage and engaging in free trade. However, the challenges of implementing fair trade has soured relations, which has led to the ongoing U.S.-China trade war. Global trade alliances have real economic consequences and are currently being reshaped. Should evolving geopolitics turn the world away from globalization, the effect on the global economy and markets could be profound. For instance, manufacturers have been shifting away from the “just-in-time” inventory model to one that needs to account for unexpected and profound bottlenecks. Unfortunately, this will lead to higher costs and lower profit margins.

The Fed and Congress have taken unparalleled measures to address these historic events, and it's fortunate that the U.S. dollar continues to represent roughly 60% of the world's reserves, allowing Washington, D.C., to take these unprecedented actions. But is dollar dominance also a tide that is beginning to turn? U.S. sanctions have forced some countries and businesses to trade with each other outside the system based on the U.S. dollar. Furthermore, China has quickly become a formidable challenger as a potential global leader, dispelling its reputation as a provider of cheap but inferior products. We have been carefully observing the early phases of this potential tectonic shift. As thoughtful investors, we must recognize that actions that help today, like the stimulus, may have lasting economic consequences such as a skyrocketing deficit. This impact will shape our long-term asset-allocation decisions.

Fundamentals tell us that threats and opportunities exist, but we understand it will likely take a catalyst (such as, deregulation and tax-law changes) to convert short-lived momentum into a lasting rotation. For example, valuations between growth and value stocks have reached historical extreme points, but moving too early can be destructive to portfolio performance. We are keenly aware that cheap assets can often become even cheaper. Therefore, it seems prudent to see those catalysts materialize before meaningfully increasing allocations to value stocks.

As always, we believe that vigilance paired with patience will prove to be prudent. For instance, real assets such as real estate also will need to adapt to changing lifestyles. Real-estate developers and investors need to address underutilized spaces (for example, retail and office) and look toward future property uses (such as datacenters and logistics warehouses). Additionally, bank-lending standards have recently tightened, which could slow the recovery but remove weaker borrowers from the system. Using quantitative and fundamental insights, our goal is to cut through the noise, focus on our strategic objectives, and look for warning signs that would cause us to course-correct.

For more insights from Pacific Life, visit
Annuities.PacificLife.com

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. Bloomberg Barclays U.S. Aggregate Bond Index

The **Standard & Poor's 500 Index** (S&P 500) is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

The **EAFE Index**, commonly called the MSCI EAFE Index, is a stock index that covers non-U.S. and Canadian equity markets. It serves as a performance benchmark for the major international equity markets as represented by 21 major MSCI indices from Europe, Australasia, and the Middle East.

The **MSCI Emerging Market Index** lists constituents from 24 emerging economies including China, India, Thailand, Brazil, South Africa, Russia, and Mexico. The index was launched in 1988.

Past performance does not guarantee future results. All investing involves risk, including the possible loss of the principal amount invested.

This commentary represents the views of the portfolio managers at Pacific Life Fund Advisors LLC as of 5/20/20 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 portfolio managers and could be different if provided by a third party.

Third-party trademarks and service marks are the property of their respective owners.

Pacific Life Fund Advisors LLC (PLFA), a wholly owned subsidiary of Pacific Life Insurance Company, is the investment adviser to the Pacific Select Fund (PSF). PLFA directly manages certain PSF funds-of-funds.

Variable insurance products are distributed by **Pacific Select Distributors, LLC** (member FINRA & SIPC).

Pacific Life refers to Pacific Life Insurance Company and its affiliates, including Pacific Life & Annuity Company.

VLCI822-0720W

3 of 3



THE OFFICIAL SPONSOR
OF RETIREMENT®