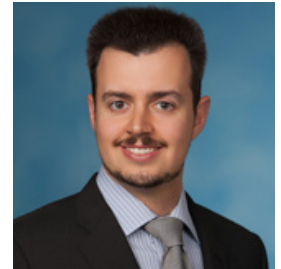


# MARKET REVIEW AND OUTLOOK

3<sup>rd</sup> Quarter 2020



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Households around the world remained in semi-quarantine amid a resurgence of coronavirus infections, which has served to maintain the wide pandemic-generated gap between winning and losing sectors. Continued work-from-home arrangements have fueled demand for technology products and services, which drove information technology (IT) stocks to new highs, while the COVID-19 fallout continued to damage large parts of the global economy, including travel, restaurants, entertainment, and retail.

While U.S. small-cap stocks trailed mid- and large-cap stocks during the quarter, markets displayed hints of rotation as small-cap value began to outperform large-cap growth. International equities finished behind U.S. stocks for the quarter, as the U.S. equity market generally had higher exposure to the technology (tech) sector. Emerging-market equities fared well, driven primarily by strong performances from the three largest representatives of the MSCI Emerging Markets Index (China, Taiwan, and South Korea).

Within fixed income, high-yield bonds and bank loans benefited from a contraction in credit spreads during the earlier part of the third quarter.

## Outlook

Investors navigating the uncharted waters of 2020 have faced one economic storm after another. We believe, as always, that to survive and even thrive in these choppy seas means planning for a full range of possible outcomes from looming geopolitical events that can quickly and profoundly change the markets' trajectory.

## COVID-19 Impacts

Investors remain focused on the global economic effects of the coronavirus. For many politicians, COVID-19 has become the scapegoat for the slumping economy, despite other contributing factors that are exogenous to this virus. The reality is, both COVID-19 and other economic elements have delivered a devastating blow for some companies but also have created growth opportunities for others.

Tech giants had the strongest performance, by far, during the pandemic. The lack of strong growth for traditional businesses and U.S. households still shell-shocked by the COVID-19 shutdown have driven investors to pour their money into a few dominant companies and sectors, such as U.S. large-cap growth stocks, leading to extremely high valuations for many of the mega-cap tech firms. Some of these powerhouses—with less-than-transparent business and revenue models—have benefited from abundant sources of capital, cheap labor (i.e., independent contractors with little-to-no employment benefits), and persistent demand.

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

For years, the tech sector has increasingly impacted our lives and disrupted traditional industries, as reflected in the performance of the stock prices. However, price multiples on some large-tech companies are becoming hard to justify at current levels, even when considering how they have benefited from the work-from-home shift. Moreover, the prospect of tech regulation looms large—regardless of the outcome of November’s U.S. elections.

Fundamental factors such as relatively strong cash flows and low debt can create a strong foundation for companies, but how they deploy those assets will likely determine their futures. For instance, properly investing in capital expenditure and/or research and development will likely serve a company well. However, many studies show that some corporate executives have instead resorted to share repurchases (or buybacks) to boost earnings-per-share and stock prices. (It should be noted that buyback activity has drastically dropped in recent periods.) While there are valid reasons for buybacks, such as a lack of business opportunities in a low capital-gains tax environment, investing in favorable business opportunities may create a sustainable path for a company’s growth

### Small-Cap Struggles

On the opposite end of the spectrum, small-cap value companies have been neglected as regional financial institutions (which represent the largest sector in small-cap value indexes) struggled to keep up with the high costs of regulatory requirements and digitalizing their operations. Another large headwind for many financial institutions was the low interest rates that have hurt profitability. Although the Federal Reserve 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 high-growth counterparts. This is particularly true as politicians have increased scrutiny on the tech giants and begun to show more empathy toward smaller companies.

Although valuations for small-cap value remain appealing, it would seem prudent to carefully assess the entire situation before overcommitting to any particular asset class. For example, we still see potential dangers for small financials if the U.S. government does not find a more permanent solution to replace the temporary COVID-19 economic responses such as the federal moratorium on evictions. We will anticipate and

carefully plan for a range of government responses to soften pandemic-induced impacts on the economy, including the next (and we believe necessary) fiscal stimulus with the U.S. presidential election less than a week away.

### Outfall from the U.S. Presidential Election

Given the generally opposing objectives between President Trump and former Vice President Biden as well as Republicans and Democrats, November’s election can meaningfully alter the course of America and therefore the rest of the world. For example, Trump and Biden would probably take different approaches to China. Trump has taken a strong stance with a domestic-centric focus, while Biden and his party may be unwilling to take on China President Xi’s aggressive push to make China great again. Trump has emphasized an “American First” strategy for the U.S. economy, but Trump’s domestic focus has been on investing in industries in secular decline, such as fossil fuels, rather than on up-and-coming industries that may drive the next economic revolution.

With access to a mature and diverse capital market, U.S. tech is mainly funded and supported by the private sector. While Trump has pushed for investments in yesterday’s industries, crude-dependent countries, such as Saudi Arabia (along with SoftBank Group Corp.), have committed nearly \$100 billion to fund a sizable portion of the largest tech-investment fund launched by SoftBank in 2017.<sup>1</sup> Investments like these provide capital for startups and pre-IPO companies, which may represent the future darlings of Wall Street.

On one hand, the Chinese government gives unfair and monopolistic advantages for its domestic companies, which makes it difficult for Western companies to compete in a globalized world. Countering this is a Democratic Party in the U.S. that seems to have plans to chop up tech giants, which may provide more balance among domestic competition. However, fragmenting tech giants may weaken the U.S. tech sector’s ability to compete with China’s rapidly growing industries that have quickly gained global market share. Given these circumstances, the outcome of the U.S. presidential election will likely have a lasting impact on how the global economy and markets shape up for the next several years.

<sup>1</sup>Source: <https://www.wsj.com/articles/softbank-saudis-to-launch-100-billion-tech-fund-1495270854>

## A Reshaped Foreign-Exchange Market?

Over the longer-term, we could see some gradual changes in the currency markets that will have profound effects on other asset classes. While the U.S. dollar, the yen, and the euro are among the most widely traded currencies and considered “safe,” geopolitical confrontations may slowly alter the landscape. The rivalry between the U.S. and China has the potential to have long-term effects that could reshape the foreign-exchange market. In Europe, the status of London as the global hub for currency trading is in flux as Brexit negotiations continue between the U.K. and the European Union (EU). Meanwhile, the EU has plans to invest heavily in technology and green initiatives, as the economic union may feel the urgency to catch up to the U.S. and China. In Asia, Japan—which still maintains a sizable

representation in developed international equity markets—will need to adjust to newly elected Prime Minister Yoshihide Suga. The Japanese economy has shown steady improvements in recent months, even with the postponement of the 2020 Summer Olympics. If a COVID-19 vaccine can be produced in time, Japan would greatly benefit from the Olympics taking place next summer.

The year 2020 has been unique in the history of America, the economy, and the markets. What’s going to get investors through this volatility is careful planning that encompasses maintaining strategic investment objectives while buffering from exogenous factors, such as the number of geopolitical events that has caused and will likely continue to cause volatility across global markets.

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The MSCI Emerging Markets Index tracks the performance of equity stocks in selected emerging foreign markets.

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