PACIFIC FUNDS

Heat Check: Investors Rethink Market Leadership

Informational commentary from Rothschild & Co Asset Management US Inc., the subadvisor to the Pacific Funds℠ U.S. Equity Funds.

What Happened

R. Daniel Oshinskie, CFA

Chief Investment Officer
at Rothschild & Co

32 Years of
Investment Experience

Driven in part by concerns over the magnitude and speed of recent interest-rate increases, investors have soured on stocks, especially in the Technology sector. Many of these issuers had previously been considered "can't miss" darlings of the market; with that myth now shattered, their fall has been dramatic, possibly exacerbated by systematic selling by commodity trading advisors and risk-parity funds. As a result, the stock price for some of the market leaders in the Technology sector declined approximately 20% in the month of October, bringing the NASDAQ Composite Index into "correction" territory (down 10%).

After an extended run of strong corporate performance, merely meeting earnings expectations has become akin to having missed earnings targets. As a result, companies that match earnings consensus have been significantly punished by the market. While harsh, the market's view may reflect a belief that profitability margins have peaked due to rising freight, raw materials, and labor costs.

Concerns about global growth are also weighing on markets. Trade tensions between the U.S. and China are providing market headwinds. While not new, there are increasing signs of protectionism taking its toll on global economic growth, as U.S. exports declined 3.5% in the third quarter. Moreover, initial hopes for a quick resolution to tensions between the U.S. and China have been dashed following a breakdown in recent talks.

Technical factors may also be at work, with many issuers currently in a blackout period for stock buybacks, because regulations prevent companies from buying back their shares during the month leading up to reporting their quarterly results. Research from Goldman Sachs had previously estimated that 86% of the companies in the S&P 500® index entered this restricted window starting October 5. As share buybacks through the second quarter had increased 50% year-over-year, it is possible that the current blackout period has removed another source of support for equities.

A final explanation for the recent spike in volatility may simply be that the market was overdue for some turmoil. Earlier in 2018, the S&P 500 index had completed a 50-trading-day session streak without a 1% swing in either direction for only the fifth time during the past five years. It was a period of calm almost long enough to make investors forget that the domestic-equity market (as measured by the S&P 500 index) had swooned about 10% in February, only to rebound strongly from those lows.

Investment Outlook

Although the factors outlined above keep us vigilant as portfolio managers, on balance we believe the economic prospects remain positive. As implied by the word "correction," the conventional wisdom is that market declines of 10% or more can provide a healthy resetting of investors' expectations.

The steep declines in Technology stocks also serve as a good reminder of why we look to control risk through limiting our sector exposure as compared to fund benchmarks. Interestingly, the recent rotation out of the Technology sector doesn't appear to us to be valuation-driven, as investors have bid up traditional defensive sectors (namely, Real Estate Investment Trusts and Utilities), rather than seek out more reasonably priced stocks. In our view, fears of a recession are overblown. While the yield curve has flattened, it has not inverted; and although rising interest rates have dampened sales of homes and automobiles due to consumer loans becoming more expensive, in our opinion, both business and consumer confidence remain strong.

As stewards of investors' capital, we are careful not to get caught up in sector rotation, reversals, and other market moves that may be fleeting in nature. As always, we stick to the basics: building portfolios from the ground up, stock-by-stock; buying stocks that we believe have attractive valuations and the potential to exceed investor expectations; and ensuring that we position the funds accordingly through strict risk controls. This may not result in immediate outperformance, but over the long haul, we believe that this measured approach will serve our investors well.

For more insights from Pacific Funds, please visit PacificFunds.com.

Definitions

Risk parity refers to an asset-allocation strategy intended to balance the risks from different asset classes to which a portfolio would be subject.

The **NASDAQ Composite Index** is the market capitalization-weighted index of more than 3,300 common equities listed on the NASDAQ stock exchange.

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.

Disclosures

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Mailing address:
P.O. Box 9768, Providence, RI 02940-9768
(800) 722-2333, Option 2 • www.PacificFunds.com

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