PACER ETFs



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Investing in a Rising Rate Environment

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On September 16, 2026, the US Federal Reserve raised interest rates for the first time since July 26, 2023. Central banks typically raise interest rates to slow inflation and moderate economic growth. While the Fed controls short-term interest rates, 10-year Treasury yields spiked from 5.0% to 5.3% by the end of September, the highest rates since 2004, before settling back towards 5.0% in November. Markets are clearly concerned that inflation will be difficult to control, as geopolitical conflicts drive commodity price inflation that is insensitive to monetary policy. Real interest rates are also rising sharply as technology companies and sovereign issuers continue their borrowing and spending sprees, increasing demand for debt capital.

Rising Rates Make Fixed Income Increasingly Attractive Compared to Equities

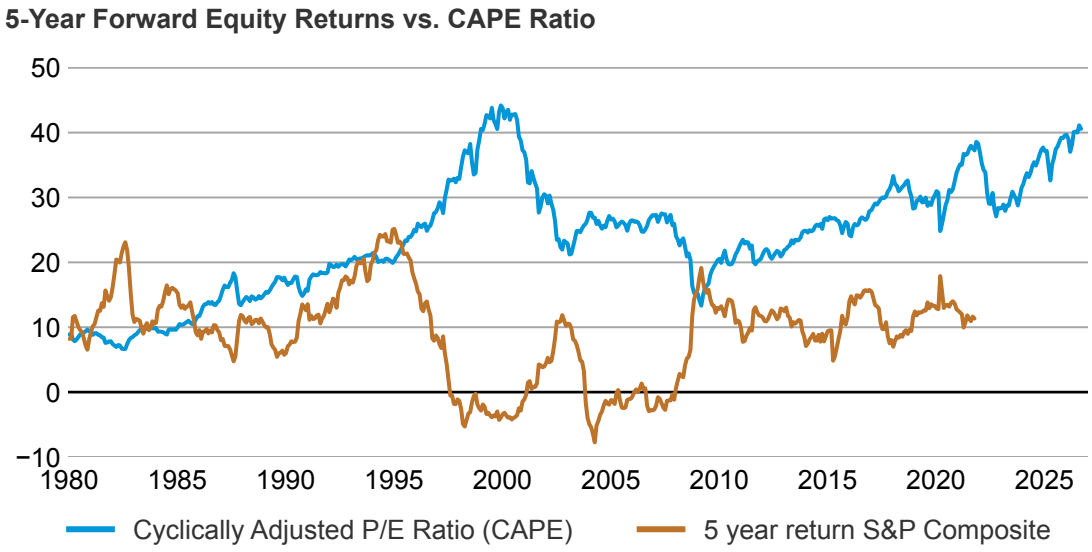
As interest rates and equity valuations change, investors may modify their allocation between stocks and bonds. With 10-year Treasuries yielding 5.0% on November 11, 2026, some investors may reduce equity holdings to reinvest in credit instruments. The Fed Model, popularized by Alan Greenspan, compares the 10-year Treasury yield to the earnings yield of the S&P 500 Index. Stocks are considered to be fairly valued when the earnings yield equals the 10-year yield. With the S&P 500 trading at a trailing P/E ratio of 26.0 as of November 11, 2026, the earnings yield of 3.85% (1/26.0) is much lower than the 10-year yield of 5.0%, suggesting stocks are overvalued.

There are two key reasons why bonds may become more attractive than stocks after a period of rising rates. First, investors may be seeking a total return target for their portfolio, such as 8% annually. After bond rates rise from 4% to 5%, investors may find bonds relatively more attractive than stocks, as the rising yield on bonds can justify a larger allocation, potentially earning a higher portion of the total return target. Second, stocks are valued as the present value of future dividends or cash flows. As interest rates increase, a higher discount rate is used, which reduces the present value of future cash flows. Stocks with negative cash flows and little-to-no dividend yield are

termed long duration stocks. Long duration stocks may struggle during times of rising rates, because the expected time to generate substantial dividends or cash flows is long into the future.

Equities Have Unsustainably High Valuation Multiples and Earnings Growth

US equities earned strong returns from 2020 to 2025, driven by exceptionally strong real earnings growth. While long-run real earnings growth has averaged 1.5%[i], real earnings growth since 2020 has averaged 5.5%[ii]. This level of real earnings growth is unsustainable, as real GDP grew by only 3.3% annually over the same period, while corporate profits grew much faster than the underlying economy. In the long run, corporate profits must grow at or below the rate of economic growth, or corporate profits would become an ever-growing portion of the economy.



Source: Robert Shiller, Author Calculations

While rising rates create headwinds for equity returns, equity valuations are near record highs as measured by Robert Shiller's cyclically adjusted P/E ratio (CAPE). Since 1980, the CAPE ratio has had a -0.53 correlation with subsequent five-year equity market returns. While strong earnings growth has supported equities so far, slowing earnings growth may leave the market with substantial downside risk. However, if the exceptionally strong earnings growth since 2020 continues, the market may stay at high valuation levels for an extended period.

At High Valuation Levels, Investors May Consider Rotating to Value Stocks and Defensive Industries

Business cycles can also influence the relative returns across equity market sectors. As the Fed raises rates to slow the economy, defensive sectors such as health care, consumer staples, and utilities may be attractive[iii]. Companies and sectors with high debt loads may face rising borrowing costs and restricted access to credit as the economy slows.

Growth stocks outperformed value stocks from 2007 to 2020 because of the low-interest-rate environment. Value stocks tend to outperform during times of rising rates and weaker stock market returns.[iv] Stock returns tend to be higher during monetary easing and lower during higher rates and monetary tightening[v].

Investors may adjust their asset allocation and sector diversification amid headwinds from both equity valuations and higher interest rates.

Pacer ETFs to Consider During Times of Rising Rates and Weakening Stocks

Investors may wish to consider the Pacer US Cash Cows 100 ETF (COWZ), which holds the 100 companies in the Russell 1000 Index with the highest free cash flow. Companies with larger cash flows receive larger weights in the portfolio. With a recent price-to-earnings ratio of 16.00 (as of 9/30/26), COWZ has strong value characteristics that may make the fund defensive in a selloff led by high-valuation growth stocks.

As interest rates rise, long-duration fixed-income assets tend to decline in value. During rising-rate periods, investors may choose to shorten duration or move into floating-rate loans. As interest rates rise, coupons on floating-rate loans increase, reducing the price impact of rising rates on fixed-income assets. The Pacer Aristotle Pacific Floating Rate High Income ETF (FLRT) invests across senior secured bank loans, collateralized loan obligations (CLOs), and floating-rate high-yield bonds.

Finally, Pacer offers three buffer types: conservative, moderate, and flex, that use equity options strategies to reduce investment risk. Conservative strategies offer buffers against market losses between -5% and -30%. Moderate strategies offer buffers against market losses from 0% to -15%. The flex strategy offers buffers against market losses from 0% to -20%, with partial protection from -20% to -40%. To receive the benefits of buffered returns, investors sell a portion of the equity market's upside. Historically, the flex strategy offers higher upside-capped returns than the conservative or moderate strategies. The Pacer Swan SOS Fund of Funds ETF (PSFF) offers diversified exposure to each underlying buffer ETF. PSFF is actively managed to ensure that cap levels are updated frequently.

Conclusion

With markets expecting another 3 to 4 increases in the Federal Funds rate through 2027[vi], interest rates are likely to remain higher for longer. Understanding how asset class returns respond across the business cycle and in high- and low-interest-rate environments can help investors adjust portfolio allocations to reduce risk in the next phase of the cycle.

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i Expected Returns on Major Asset Classes, Antti Ilmanen.
ii https://www.officialdata.org/us-economy/s-p-500-earnings-inflation-adjusted
iii The Business Cycle Approach to Asset Allocation. Hofschire, Weinstein, and Dourney.
iv Factor-Based Investing in Market Cycles: Fama–French Five-Factor Model of Market Interest Rate and Market Sentiment. Kuo and Huang. Journal of Risk and Financial Management
v Ibid
vi https://www.morningstar.com/economy/whats-ahead-2027-beyond-inflation-fed-rate-cuts-more

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Duration measures a fund's sensitivity to interest-rate risk where the longer a fund's duration, the more sensitive, and vice versa.

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