



## FLIRTING WITH RECESSION

The Fed's mission to tame inflation has already battered fixed-income markets. Is a recession next?

*On July 13, 2022, we sat down with Dominic Nolan, CEO of Pacific Asset Management, to get his insights on the markets' poor performance so far this year, the Fed's quest to tame inflation, recession fears, consumer spending trends and opportunities in fixed income.*

### Can you put the poor market performance so far in 2022 in historical perspective?

The first half of 2022 was the worst first half for the S&P 500 since 1970. And I think it's the worst bond market in modern-day history—I would call it the total-return era. It's been a rout.

The best way to break down the first six months of this year would be this: The first quarter was about rising rates and the second quarter was about the markets adjusting to recession probabilities. The constant in both of these quarters was elevated inflation.

### Do you see any signs for optimism?

I do, actually. The empirical data would tell you there is historical precedent that you may get a rally.

The worst first half was in 1932, during the Depression, the stock market was off 45%. What did it do in the second half? It was up 53%. When you go through the next four worst first halves of the year since then, here's what you see: In 1962, down 27% for the first half and up 20% for the second half. In 1940, down 21% and then up 7%. In 1970, down 20% and then up 25%.

And in 1939, down 18% and then up 16%.

I believe we are hitting peak inflation. The June CPI numbers are, quite frankly, a horrible print. Headline CPI numbers for June are 1.3% for the month and 9.1% year-over-year. So inflation, according to CPI, is accelerating. Core inflation is up 0.7% for the month and many of the subcategories are above expectations. Fed Futures post-CPI are pricing in an approximately 55% chance of a 100-basis-point hike later this month. This is up from probabilities of a 75-basis-point hike and also pricing in probabilities of another 50-basis-point hike in September. Just two months ago, Fed Futures indicated 50 basis points in June and 50 basis points in July. Where we stand today, we already have 75 done in June and probabilities of a 100-basis-point hike in July. So the Fed, again, being forced to move aggressively, is going to end up hiking somewhere between 150 to 175 basis points in June and July largely.

When you get to the qualitative side, I am seeing signs of more supply/demand equilibrium. Demand is waning, and prices are easing in certain areas. I just think there's a ton of bad news already priced in. On the credit side, I think what's been priced in is overly pessimistic. So, what's already priced in gives me some optimism.

The 2-year Treasury is now trading into 3.1% yield. The 10-year Treasury is trading it at 2.9% yield. the curve is currently inverted. Historically, within a year of this, there's either been recession, or a rate cut. A rate cut without recession, that's a soft landing. You get both, we probably have a hard landing. What could change

this? Well, flip it back again to some signs of optimism. We're seeing metals prices on the forward curves dropping along with other commodity prices, trucking freight rates are rolling over and M2 is slowing. With these forward indicators dropping, it could lead to a more normalized inflation print. We'll see.

**We seem to be flirting with a recession. As a rule of thumb, a recession has been traditionally defined as two consecutive quarters of negative GDP growth. With that in mind, are we in a recession now?**

That's a tough question. By what I'll call the academic definition, which you just gave, I'll say, "Yes." Q1 was negative. Q2 real GDP will probably be negative. If you look to the slowdown in economic activity and real income, that answer would be a yes. But now you have employment. Employment to me is still healthy, so that could indicate no recession. When you look at industrial production right now, it could also indicate no recession. So, are we in a recession? The answer to that is academically, yes. But I'm not a believer. I'm just not there yet.

**How do you see recession fears affecting consumer sentiment?**

Consumer confidence is low. People are watching their pocketbook more. I think what really hurts the psyche is that across the country in every state, every county, every city, people are driving past gas stations and seeing the high prices. Certainly, it's the same thing at the grocery store. So, food and energy prices are hurting the consumers' psyche. Absolutely. What's holding the line right now is the job market. While we are seeing jobless claims tick up a little bit, there's still a need for labor. If we start seeing massive layoffs over the next 60 to 90 days as corporations tighten up, then I would be much more concerned. I think jobs are just so important.

**The Federal Reserve has admitted being late to act on inflationary forces in the market. And they've used that admission to justify its largest hike since 1994, the 75-basis-points hike that we had in June. Where did the Fed go wrong?**

To me, the level of recent rate raises is not the mistake. The timing was the mistake. The Fed was comfortable in letting inflation run hot and above target, and it got away from them.

**What do you think is next in the Fed's rate-hiking cycle?**

Fed funds target rate range right now is 1.5-1.75 with 100 basis point hike in June. That takes us to 2.5-2.75. If you get 50 basis points in September, we'll be at 3.25. Odds are, if they just go quarter point after that, we hit approximately 4% by the end of the year. That's high to me. Also, it's important to note that markets are beginning to price in a rate cut in 2023. The market is essentially saying, "The Fed's going to overshoot, and then they're going to have to cut." To me, I think they should stop around the neutral side, which would be about 2.5% to 2.75% and just let the tightening monetary conditions take hold. But as determined as the Fed was to let inflation run hot, they seem as determined to hike aggressively, invert the curve and make economic conditions harder.

**Is there a scenario where the Fed changes its aggressive stance this year?**

If inflation starts to roll over, the Fed can be more neutral, monetary conditions can ease a little bit, and you can have a more normal functioning economy. I would say if the July or August data indicates that inflation has peaked or the CPI is cooling off a bit, the Fed will have room to not be as aggressive, is that likely

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to happen? We'll see what the August and September prints come in at. To me, the September meeting is what will be really interesting. If inflation has declined, I think they'll have more wiggle room to talk their way out of their current aggressive course of action.

### **To what degree are the inflationary forces outside the Fed's control at this point?**

I believe most factors are out of their control. In my opinion, the root causes of inflation are supply-chain disruptions (which are continuing because of China's COVID policies), and the Ukraine situation disrupting food and energy. Those are largely out of the Fed's control.

### **Let's turn to consumer spending. When you look across sectors of the economy, what is the view telling you?**

When I look through Bank of America daily credit card data—and this is through mid-June—the biggest month-over-month increases were in gas, airlines and groceries. Now a lot of that's just inflation, so real spending is probably flattish. But people are traveling; they're out and about and enjoying their summer. Compared to pre-COVID 2019, total spending's up about 22%. Lodging's up over 30%; restaurants are up over 30%; and gas is up over 40%. That's pretty healthy. I've heard this large increase in vacations called "revenge traveling" because travelers were forbidden to do it so long, and now they going to make up for lost time. Also, people have more freedom to work remotely, which means some of them are working at times away from home.

### **Given what's happened so far this year in fixed income and what's expected from the Fed in the coming months, how do you make**

### **sense of today's fixed-income markets and where are the opportunities?**

Let's start with yield levels. In particular, the Bloomberg US Aggregate Bond Index yield of 3.71%. Mind you, this is the broad-based investment grade index that had a 1% yield just a couple years ago. The corporate index yield is now 4.7%. This is investment-grade corporate. That used to be the yield for U.S. high yield, with BBB corporates crossing over 5%. U.S. high yield is close to 9% with BB yield-to-worst at 7.25%; single B at 9.5%; floating rate loans' current yield is 5.5%.

When you look through to where the fixed-income markets are, I've said for months that credit looked interesting but not attractive. I am now officially in the camp that credit looks attractive, especially if you have a 2- to 3-year time horizon. On the loan side at \$92, there are times that loan prices were lower: Global Financial Crisis in 2008, the COVID crisis in March 2020, the European Financial Crisis in 2011 and the energy crisis in 2016. I think all four of those environments to me are worse than they are today, but that's where loan prices sit.

I believe that one of the beautiful things about credit is you can use math to back into what loan yields are pricing in. In our analysis, current prices are suggesting an implied default rate of over 6%. That is per year for the next four years with a 55-cent recovery, which is also below historical recovery rates. If we actually got those default rates with those recoveries, that may be a pretty severe recession. When I look at credit in general, you're seeing a wide selloff. I think it's attractive. We'll see how this shape shapes up over the next 12 months, but very constructive on my end at this time.

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**Time for the lightning round. I'll give you a word, short phrase, or question, and you tell me the first thing that comes to your mind. Are you ready?**

Let's go!

**Gasoline prices.**

Absurd. I'm California, so it's especially absurd.

**The energy sector.**

Still distorted.

**Ongoing impacts of Russia/Ukrainian war.**

It hurts millions of people, even over here. Food and energy will be disrupted for a long time.

**The Fed's goal of inflation falling to 2% within two years.**

Unlikely, but a possibility.

**The economy and midterm elections.**

In the red.

**Airline pilot and truck driver shortages.**

We need skilled labor. We need labor in general.

**Cryptocurrency meltdown**

Feels like 2001 NASDAQ

**The U.S. dollar.**

Stronger than people expect.

**Before we wrap up, can you share with us a personal reflection?**

Sure. We recently celebrated Independence Day. I was not born in this country, but I'm a citizen. The 4th of July reminded me that we should never take for granted our independence and the principles upon which our country was founded. When I think about the past year or two, I see some of our base freedoms are being tampered with, and it breaks my heart. I think we all have a responsibility to preserve them. In my opinion, individual freedom demands individual responsibility. And I don't take that lightly.

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