PACIFIC FUNDS insights
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WILL THE FED PUT IT IN NEUTRAL?

With inflation indicators rolling over, will the central bank signal an end to the rate hikes?

We recently sat down with Dominic Nolan, CEO of Pacific Asset Management, to get his insights on the Fed's latest signaling, recent market action, U.S. economic health, and opportunities in fixed income. We finished with a speed round of questions and a personal reflection.

We saw a split in performance in October with a big rally in equities after a difficult September, but steadily higher rates put pressure on fixed income. What did we learn from October for the balance of 2022?

There was a pretty heavy rally in equities as the S&P 500 Index was up over 8%. Meanwhile, longer duration fixed income sold off, which is more of a normal functioning market. I think this reflected a couple of things: First, initial GDP reports were that we had real growth in Q3 after negative real growth in Q1 and Q2. Second, I think the market was hoping we are closer to a fed neutral rate.

When you go over the numbers, again, the S&P was up 8% in October but still down almost 18% for the year. The tech-heavy Russell 1000 Growth Index was up 6% for October, but down 26% for the year. The Russell 2,000 Value Index was the standout. It was up over 12% for the month and is down 11% for the year. So, traditional and smaller market cap businesses are performing substantially better than tech heavy indices. Internationally, the MSCI World Index underperformed the S&P; up 5% for the month and down 23% for the year.

What about fixed income?

The Bloomberg US Aggregate Bond Index (Agg) was down 1.3% as the 10-year Treasury climbed and closed the month at 4.07%. It's amazing. The 10-year Treasury was 1.6% a year ago, so it has more than doubled in yield since then. For the year, the Agg is down almost 16%. When you go over to leverage finance side, high-yield bonds were up 2.5% in October; for the year, high yield is down 12.5%. Floating-rate loans were up about 85 basis points, but for the year, down roughly 2.5%.

What's the big picture here?

If you have a balanced portfolio, you're most likely down roughly 16 to 17% for 2022 thus far. That's a very tough year, but I think we're seeing a more normal functioning market now where not everything is getting ripped apart. Hopefully, that indicates a market that is stabilizing, but we'll see.

Let's talk about the Fed. Is the central bank looking to put its rate-hike cycle in neutral?

The Fed's FOMC meeting this week was interesting, The Fed raised rates by 75 basis points, leaving the fed funds rate between 3.75%-4%. The markets rallied with the release of the policy statement, which indicated the Fed will take "cumulative tightening" and "lags" into account. A lot of the folks,

including myself, had been worried the Fed was looking too much at rearview-looking data. And if they were using that to dictate policy, many of us felt the Fed was surely going to overshoot. So, acknowledging they will take into account things that are lagging, you felt the Fed should get to neutral quicker. The markets viewed this statement as a dovish tilt and thus began to rally. Initial guidance at Chair Powell's press conference, he indicated the downshift could come "as soon as the next meeting." The market rally peaked right here.

Then Chair Powell turned more hawkish, noting the terminal rate maybe higher than what the Fed's DOT Plot had been at their previous meeting. So that indicates 5% is not quite enough. It's probably going to be higher than that. In other words, a pause is not in the cards right now. That's when the market really sold off. My conclusion is that they could slow the rate-hike pace next month, which is dovish, but there's no sign that a pause is coming as the terminal rate is expected to be higher. The markets are now digesting the Fed will likely to continue raising rates beyond when the market's expected a week ago.

So where does that leave us with the base case?

Base case right now: 50-basis-point raise in December, 50 in February and 25 in March. That would take Fed funds to 5%-5.25%. Now mind you, a week or two ago, the market was feeling 25 basis points in February and a pause. It quickly moved to 50 in February and 25 in March and a 5.25% pause.

You mentioned Q3 GDP came in positive after two quarters of negative growth. So how does growth look so far in the fourth quarter?

Fourth-quarter growth right now is tracking above 2%, according to GDP Now, and we do have the holidays coming in. Q3 growth on the advanced estimate came in at 2.6%, which means for the year we are positive as an economy. Q1 real GDP was -1.6, Q2 is -0.6 and then Q3 was 2.6. The expectation is that overall real GDP will be slightly positive for the year.

I want to look through to what's happening in the economy. What's clearly happening is that consumer spending is slowing down according to daily credit card data from Bank of America. For context, I would say spending has been up across the board relative to three years ago, pre COVID, except for one category; department stores. The department-store secular shift is still in play. Department store spending is down about 5% relative to three years ago.

But what is down compared to one year ago? Clothing at -10%, furniture at -15%, home improvement at -3% and online electronics at -16%. The furniture and home improvement side has been very much a byproduct of the housing slowdown. You're seeing other consumer discretionary elements slow down substantially.

What is up over one year ago? Airline spending is up 30%. Gasoline is up 10%, but that's just pure inflation in my opinion. Lodging up is up 8% and restaurant spending is up 4%. But at the same time, all of those sectors have slowed in recent months.

I believe this trajectory indicates that we're probably heading into a recession. I'll finish on the economy addressing one more item, used cars. Used-car prices have been coming down rapidly. Remember the articles about used car prices spiking and the difficulty of obtaining a used car? Prices have come down about 15% from their all-time high in January, but they're still above pre-COVID levels. Pickups and

compacts are holding up best, while sedans and luxury have weakened. For context, the average new-car loan payment is about $660. The average used-car loan payment us about $515.

Let's look at credit. When you look at yields and prices across credit, it looks like the market is anticipating some choppiness. How does credit look right now?

I began getting constructive on credit in July and I still maintain that outlook. Let me give you a snapshot of yields as we speak. The Agg—a general broad-based investment-grade index—was above 5% at the end of October. The yield-to-worst was 5.01%. I mean, this was an index that was yielding 1% and change not that long ago. When you look through to investment-grade credit, the yields are 5.9%. The average price of an investment-grade corporate bond is $85—15 points below par. Triple B's are yielding above 6%. So, very attractive yields on investment grade right now.

Yields on U.S. high yield is at 9.1% as of a couple days ago, and the average price of a high-yield bond is $85. Floating-rate loans have been the standout performer this year, down just 2.5%. The thing that is great about that asset class is last month the performance of loans was positive AND your yield went up as well. You're seeing yields go up because the Fed has been aggressive. That is one of the few debt asset class where you can have positive returns and an increase in yield. Average price of loans right now is $91. Almost all of the debt markets are trading below par. Yields on high grade is in the mid-single digits. And on leverage finance, yields of high single digits to low double digits. Can I remain very constructive on credit? I think a lot of bad news has been priced in, and I've not changed my tune and don't expect to in the near future as it relates this area of the market.

Can you talk about floating-rate loans and the Fed's rate hikes?

Sure. With floating-rate loans, typically the underlying loan or collateral is reset anywhere from one month to three months out. As a result, when the Fed raises, there is a bit of a lag effect. As the Fed started raising aggressively during the summer, there was a little bit of that lag, but now we're seeing loans really pick up in their coupons. Coupons are moving higher at an aggressive pace. That's why we're seeing performance in that asset class that has been pretty stable. The three-month return of the loan index was up 0.22 basis points. So, it's up over the past three months when the Agg is down almost 8%, and S&Ps down 5 to 6%. Loans are up, their yields are up, and the prices have been pretty stable. It's been a very good defensive asset class against inflation.

Let's switch gears to 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?

Fire way.

Job openings.

Remains elevated.

Series I Treasury bonds.

It's got a lot of press. I wish the minimums were higher cause it's been a sound investment for anybody that has these Series I Bonds. I think it's a solid way to preserve capital and defend against inflation.

Political pressure on Fed Chair Powell?

I would assume there's some political pressure, but I

think the Fed honestly has made it clear they're not politically motivated here. They're acting independently. And I believe that to be good.

Inflation in Europe?

Worse than the U.S. because of the energy situation.

How about 2022 so far?

I think it's been a blood bath. Just to give you an anecdote here, the draw down for the long bond, I believe, is the worst in 100 years. U.S. Treasuries are down 30 to 40%, and that is substantially lower than it was in the 1980s. The reason that's the case is because the coupon rates back in the '80 were so high that they're able to buffer some of those price changes. But in this market where Treasury's started with a 1% yield, it's been pretty brutal. And that obviously has rippled through to other asset classes.

Twitter?

Above my pay grade, but that's just a lot of click bait and a bit of a mess.

Holiday spending?

I think there's going to be a lot of surprising discounts as we get into post-Thanksgiving. Companies have built up their inventory, consumer spending is slowing, and the stores need to sell. Folks haven't seen a lot of discounts for a year or two now. I think we're going to start to see that.

Can you tell us about the announcement that was made about Pacific Asset Management, the sub-advisor to Pacific Funds?

About 10 days ago, our parent company, Pacific Life, signed an agreement to sell Pacific Asset Management to a new partner. The Pacific Asset Management team and our new business partner, Aristotle Capital Management, have a distinct and shared set of values and objectives that we believe are a great fit for the business long term. We stuck to those things all the way through this transaction.

The saying that we have on our holiday gifts that we'll be sending out to our partners is: "Choice, not chance, determines your destiny." To partner with Aristotle, that was a choice. I'm proud of that choice and couldn't be happier about it.

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

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

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