PACIFIC FUNDS insights
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THE MARCH OF INFLATION

How have market expectations adjusted to recent inflation numbers?

We recently sat down with Dominic Nolan, CEO of Pacific Asset Management, to get his insights on recent market action, the resilient economy, stubborn inflation, an increasingly hawkish Fed, and opportunities in fixed income. We finished with a speed round of questions and a personal reflection.

We saw a sharp reversal for equities and fixed income last month compared to January's performance. What happened?

I think the market is really adjusting to the "higher for longer" sentiment about the Fed's rate-hiking cycle. That narrative has gained momentum in the press for the past month, and the market has re-calibrated. To give you a frame of reference, the 10-year Treasury entered February at 3.52%, and, at the end of the month, was at 3.91%. That's a substantial move.

What did it result in? S&P 500 Index was down 2.6% in February, but still up 3.4% for the year. The Russell 1000 Growth Index was down 1% last month, but for the year up 7%. So, the Russell 1000 has been doing well. Internationally, the MSCI EAFE was down last month, but still up 6% for the year.

Overall, equities were down about 2% in February, but up 3 to 4% for the year.

Bond performance?

The Bloomberg US Aggregate Bond Index (Agg) got hit. It was down 2.6% in February. We are in a world where the volatility in the belly and long end of the Treasury curve is substantial. A 2.6% loss would register as one of the worst years in index history. There is still substantial volatility in the bond market. Year-to-date, the Agg has been positive, though at just 41 basis points.

Moving to high yield, that was down 1% last month. For the year, it's up 2.5%. Bank loans, or floating-rate loans—the defender against this rate volatility—continues to chug along. Loans were up 63 basis points in February and over 3% for the year. So that floating-rate trade has continued to defend well against volatility we have faced due to inflation and Fed uncertainty.

In general, a balanced portfolio (60% equities/40% bonds) would be up about 2.5 to 3% so far this year.

The economy has looked more resilient than many thought just a month ago and certainly six months ago. Where is this resilience coming from?

In a nutshell, it's showing up in the labor markets. We're still working through significant excesses due to fiscal and monetary policy sparked by COVID. When you think about the dry powder that came in through the COVID packages, unemployment packages, corporate packages, government spending, and central bank accommodation, you took on a ton of dry powder, and, as a result, consumption and personal savings are strong.

With the backdrop, the labor market has thrived, which is really buoying the economy. Additionally, and at a global level, China has been coming out of COVID lockdowns, with its manufacturing PMI very strong this year. Also, Europe has had a warmer winter, so that's helping to prop up consumption.

On the other hand, with all that dry power, you have sustained inflation. A counterpoint is that markets continue to expect a recession later this year. In the end, I think the markets are having a tough time underwriting this economy at this time.

Let's turn to the march of inflation. Using a letter grade, how are we doing in the fight to bring it down?

I'd give it a B. Even though the market is adjusting to "higher for longer," that's a Fed narrative. When you look through, prices have been dropping. For example, you've had drops in the price of lithium, which, among other things, impacts electric vehicles. Gas is dropping. Fertilizer is dropping. Food prices are dropping. Apartment rents are dropping.

An interesting note is the temp-to-permanent employee conversion. Essentially, employment agencies say one of the first things companies will do in a downturn is keep the temps temporary, and, when they need labor, they will convert the temp jobs to permanent. Well, an index tracked by ISI has recently seen a significant drop in that conversion. During 2020 and 2021, about 40 to 50% of the temporary employees became permanent. Now, you're seeing that pulled back to where they're not only avoiding the conversion, but actually letting temps go.

Why's inflation still stickier than expected?

I think one reason is that we still have that dry powder we talked about. On top of that, consumers are spending less on goods and increasing spending on experiences such as dining, travel, and entertainment. Those service-industry activities are labor intensive.

At a higher level, we have an older population than we did 10 years ago. The largest age group in the U.S. right now is 30 to 34 years old. That's smack in the middle of the millennials. Ten years ago, we had a ton of workers in their early 20s, who were able to fill those service roles. Now the pool is probably three to four million less people in that 15- to 24-year-old age group. That has a large effect on the pool of service workers. Plus, you now have millions of millennials moving toward their prime consumption years. They are moving to the burbs, seeking housing, buying nicer cars, and beginning families. To me, that is an important but less discussed factor.

Lastly, I think the raw material and general supply chains are still constrained.

When it comes to the Fed's rate hiking, have we completely shifted to expectations of rates being higher for longer or are there more adjustments?

I feel like every three months I've had to make an adjustment: "Oh, they're going to go higher than I thought:" So where are we now? Market expectations have discounted a 100% chance of at least a 25-basis-point hike in March and a 58% chance of a 50-basis-point-hike. Those odds are going to fluctuate.

I still think the Fed's going to raise rates by 25 basis points in March, but now, expectations are for a 25-basis-point hike in May and June. Because of Chair Jerome Powell's recent testimony, September is discounting a 40% chance of a 25-basis-point hike.

If those hikes happen, that'll take fed funds rate to 5.75%, substantially higher than I would've thought. So, I'd say the markets are believing higher-for-longer rhetoric.

Given all this backdrop, when we look at opportunities in fixed income, does credit still look attractive?

I feel the same way about credit as I have since July: constructive.

Where do we sit today? Agg index after last month's sell off now yields 4.8%. From a yield standpoint, the average price of bonds is around $89 and has a duration of six years. For investment-grade credit, the index yield is 5.5% with a price of about $89. For the high yield, the index yield is 8.6% with an average price of $88. Bank loans are the ones that have defended through this rate-hiking cycle, and every time the Fed hikes, that adds to the coupon. Loan yields are on a four-year discount margin at 9.8%, average price $93. Loan prices have continued to stay around $92, $93, but yield has continued to go up, and that coupon is clipping away and providing a cushion. If you look through to investment-grade credit, if rates remain where they are at 5 to 6%, if you get compression in rates and spread compression, now you're getting into higher single digits.

Right now, from a relative-value standpoint, I love fixed income relative to equities. From an absolute standpoint, there's a chance credit beats equities. High yield is still above the S&P over the past seven, eight, nine months. We'll see how long that goes. Another note, I do not believe the loan trade is over because of the volatility in the belly of the curve. I'm remain very constructive on this.

So, you would not favor extending duration significantly at the present?

Not significantly, but again, yields just went up. Last month, duration was a headwind. In February, we had a wave of people thinking the duration trade was in, and it didn't work well. Yields have blown out 50 basis points. I think it's okay to nibble out, with the key word being nibble.

Let's switch to the lightning round. Here, we're looking for your gut reaction or extended response. First question, should we be concerned about record consumer debt?

Is it a record consumer debt? Yes. But when you look through to consumer debt as a percent of GDP, I think it's the lowest in over 30 years. So, I would say there's minimal concern at this point.

Over the past year, what did the economists get the most wrong?

Rates and recession. I certainly got the rate move wrong. The Fed's been a lot more aggressive than I would've thought, and the recession isn't here yet.

The positive effects of the COVID relief packages three years later.

The relief packages elevated interest rates, and I do believe the markets are healthier with higher rates. Pre-COVID, we were in a world of negative rates, which I didn't think was healthy for institutions and savers. From that standpoint, more liquidity to the consumer has been good. We did avoid some bankruptcies for sound businesses that didn't deserve to fold due to government shutdowns. However, those relief packages helped stem, to some degree, the negative effects of inflation.

Rate cut in 2023?

If you asked me two months ago, I would've said, "Yes." I'll now say no cuts in '23, but in '24.

Entrenched inflation like stagflation?

I've been in a camp that I feel the rate of inflation will decline and has been, but the prices will remain elevated.

Hard or soft landing for the economy?

I think the Fed is just too aggressive, but I don't know if there's going to be a hard landing. To me, the Fed's rhetoric and the fact that they're anchoring to a 2% inflation rate means they're going to be more aggressive than they need to be. I think we get into a recession. How deep? I don't know.

Buying a house today given higher mortgage rates.

If there's a house you want and you can get it, I'd say, "Great, go for it." I would be surprised if you took on a 30-year fix today and don't have the opportunity to refi lower in the next two or three years.

Major League Baseball's new pitch clock.

I think it's a positive move. I'm a big baseball guy, but it is not a fun game to sit on the couch and watch for hours because of slow play. Anything they can do to keep the pace up is a good thing.

Can you share a personal reflection to close?

My teenage daughter took a big chance and ran for class president of her high school. She really put herself out there. She did a great job in the campaign, did it the right way with the right intent. And I think deep down thought she was going to win, but it didn't go her way. She's crushed. Afterward, I reminded her of a passage from one of Teddy Roosevelt's most famous speeches called "The Man in the Arena."

I'll adjust the language to today's sensibilities:

"It's not the critic who counts, not the one who points out how the strong stumbles or where the doer of deeds could have done them better. The credit belonged to the one who is actually in the arena, whose face is marred by dust, sweat, and blood, who strives valiantly, who errs, who comes short again and again, because there is no effort without error and shortcoming."

I told my daughter than in the end, "It's the effort, not the outcome." And she did right by the effort, though the outcome's not always going to go your way. Sometimes you may lose, but with the right effort, you're going to win long term.

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