Commentary from Pacific Asset Management, the manager of Pacific Funds℠ Fixed-Income Funds.

The New Conundrum

In 2005, then Federal Reserve (Fed) Board Chair, Alan Greenspan, stated that Treasury yields were a "conundrum" because a year into the Fed's 2004—2006 tightening cycle, Treasury yields were moving lower in spite of the Fed raising the federal funds target rate. Today, Federal Reserve Board Chair, Janet Yellen, is faced with a new conundrum. A relatively steady economic cycle, a much improved labor market, and signs of wage inflation would argue for more tightening, but these trends are being balanced by weak economic growth, strained global economies, and extraordinary policy measures by foreign central banks.

The Dual Mandate Says Hike

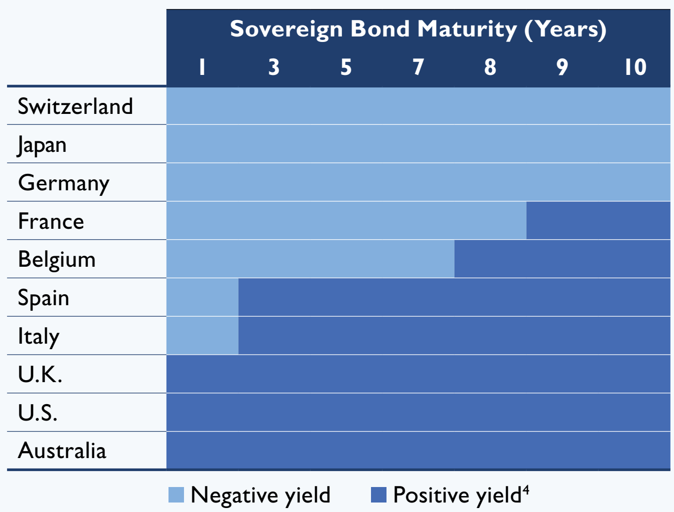
From the framework of full employment and price stability, the case for the Fed to raise the fed funds rate[1] appears straightforward. The unemployment rate has fallen below 5%, a level considered by the Fed to be full employment. Recent labor market data has been strong, with underlying data suggesting employee confidence. The Job Openings and Labor Turnover Survey (JOLTS) shows that job openings are high and quit rates are on the rise.

As for price stability, core inflation as measured by the Consumer Price Index (CPI)[2] was rising, and it reached a 2.2% annual rate in July. The energy-driven drop in headline CPI in 2015 has stabilized along with oil prices (Chart 1, page 2). There is also growing evidence of wage inflation through rising unit labor costs and payroll data. The increase in many structural areas of inflation, such as wage and income growth, corresponds with a tightening labor market and extended business cycle.

Zero Interest Rate Policy (ZIRP) to Negative Interest Rate Policy (NIRP)

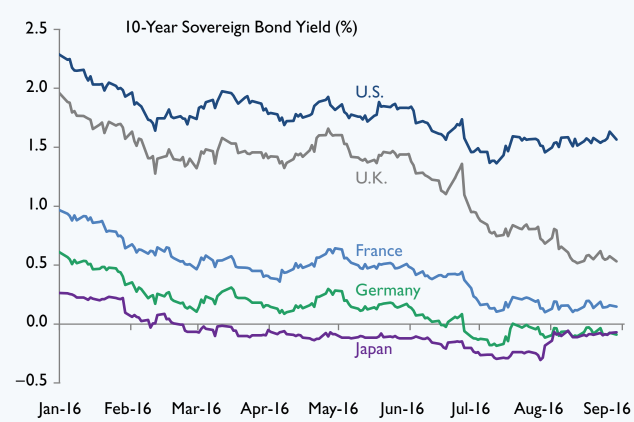
Central banks globally are moving toward NIRP as weak economic growth and increased quantitative easing (QE)[3] are helping drive yields below zero.

The Federal Reserve has been a major central bank to raise policy rates over the past year. Meanwhile, some other central banks have seen rates drop into negative territory.



Source: Barclays, as of August 29, 2016.

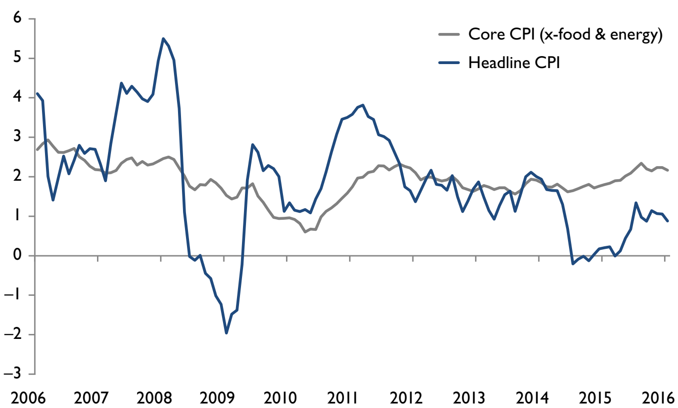
A combination of global central bank policies, weak economic growth, and some relative value appear to be keeping a lid on U.S. Treasury yields.



Source: Barclays, as of August 29, 2016

No bank guarantee • Not a deposit • May lose value
Not FDIC/NCUA insured • Not insured by any federal government agency

Chart 1: Core CPI has been rising and headline CPI has stabilized, supporting hawkish Fed's Governors on rate hikes



Source: St. Louis Federal Reserve, as of July 30, 2016.

However, since raising the fed funds rate in December 2015, expectations of Fed action in 2016 have diminished. The Fed's own expectations, measured by the "dot plots[5]," have been reduced from four rate hikes down to one or two more in 2016.

U.S. and Global Growth Warrant Caution

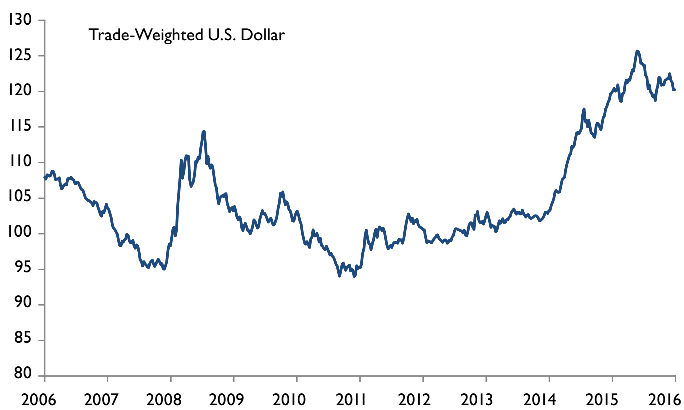
Despite a relatively steady economic expansion, growth has been anemic. Real gross domestic product (GDP) in the United States during the past five years has averaged 2.1%, far below previous economic expansions. This is in spite of all improvements mentioned above along with a near zero fed funds rate.

Additionally, global economic conditions are more worrisome, with the International Monetary Fund (IMF) forecasting a 3.1% global GDP in 2016, down from over 5.4% in 2010 in their 2016 *World Economic Outlook*. The current IMF forecast, which has been reduced twice in the past year, is the lowest since 2009, when GDP in the U.S. was negative and the economy contracted. Concerns about China and the zero growth rates of Europe show economic risks continue to be skewed toward the downside, even in the face of unprecedented central bank policies.

Aligning with Foreign Central Bank Policies: A Third Mandate?

With other large central banks moving forward with accommodative policies, our Fed's less dovish tone relative to these central banks has resulted in a de facto tightening of financial conditions. The U.S. dollar has strengthened[6] 16% over the past two years (Chart 2), acting as a form of leverage to the Fed interest-rate hike in 2015, impacting corporate profits and economic growth. The Fed's research on a strengthening dollar shows a reduction of real GDP by more than 2.5% over the past two years. The Fed's research, as discussed in Vice Chair Stanley Fischer's speech in November 2015, also shows the dollar strength to be equivalent to a 1.5% increase in the fed funds rate.

Chart 2: The strength in the dollar during the past two years is acting as a de facto tightening of monetary policy

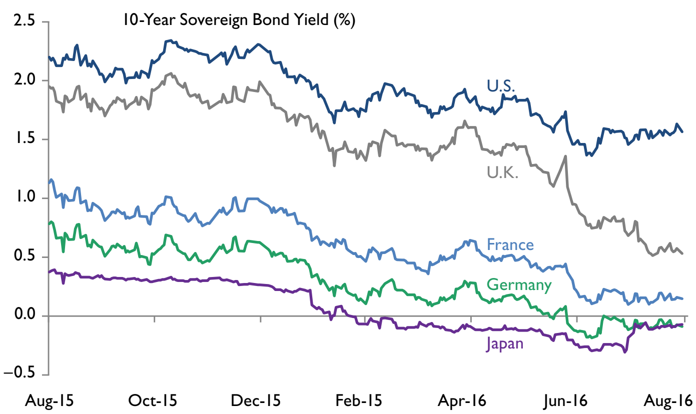


Source: St. Louis Federal Reserve, as of August 29, 2016.

Central-bank policies abroad are constraining the actions of the Fed. With incrementally aggressive policy during the past eight years, policymakers have now moved into what was thought to be impossible: negative interest rates. Moving from ZIRP to NIRP is now the next phase in the deflation-fighting playbook against the ongoing lack of aggregate demand.

Even with more than 31% of developed sovereign bond yields negative, central banks are still looking to become more aggressive. The European Central Bank (ECB), Bank of Japan (BOJ), and most recently the Bank of England (BOE), have all expanded their asset purchase programs with expectations of more to come. The ECB's Corporate Sector Purchase Program (CSPP), which began on June 8, 2016, is targeting $80 billion of corporate bond purchases per month. The BOJ's open discussion of true "helicopter money[7]" programs shows the willingness to push policy further. The BOE has recently cut policy rates for the first time in seven years, while announcing asset purchase programs in the amount of $220 billion. The effect of these programs has been to suppress term premiums[8], or decrease the extra yield investor's require to hold a longer-term bond over a series of shorter-term bonds, and support record low sovereign yield levels (Chart 3).

Chart 3: Record low sovereign yield levels



Source: Barclays, as of August 29, 2016.

Bottom line: Today's conundrum is how the Fed will uphold its dual mandate while recognizing the interdependence of global policies, economies, and financial conditions. The Fed appears to be going it alone in seeking to tighten policy. As global central banks push the scales with further quantitative easing, it amplifies even small changes in the fed funds rate on financial conditions and economic growth.

It is getting harder for the Fed to tighten[9] policy, given the influences of global factors and a weak economic cycle. It is also becoming harder, given the dual mandate, to leave rates unchanged. As a result, while we do not believe the Fed has the inclination to meaningfully raise the fed funds rate in 2016, there likely is a window to raise the rate at least once sometime during the remainder of 2016.

Pacific Asset Management

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References

[1]The federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight, on an uncollateralized basis.

[2]Core inflation reflects the long-term trend in a particular price level. It is a measure of inflation that excludes certain items that face volatile price movements because in finding out the legitimate long run inflation, short-term price volatility and transitory changes in price must be removed. Headline inflation is a measure of the total inflation within an economy, including commodities such as food and energy prices (e.g., oil and gas), which tend to be much more volatile and prone to inflationary spikes.

[3]What is QE? By purchasing large amounts of government bonds and other securities, central banks seek to drive down the yield for any maturity, magnifying the effectiveness of their interest-rate policies beyond just short-term interest rates.

[4]Yields move opposite to bond prices. If a bond has a negative yield, it means the bondholder loses money on the investment, though this is relatively unusual.

[5]A dot chart or dot plot is a statistical chart consisting of data points plotted on a fairly simple scale, typically using filled in circles.

[6]Currency exchange rates influence the attractiveness of exports. A stronger currency hurts company earnings because U.S. exports become less competitive with goods produced abroad, and if corporations haven't hedged overseas profits, they translate into fewer dollars.

[7]Helicopter money has been proposed as an alternative to QE when interest rates are close to zero and the economy remains weak or enters recession. Helicopter money is a hypothetical, unconventional tool of monetary policy that involves printing large sums of money and distributing it to the public in order to stimulate the economy.

[8]The term premium is the excess yield that investors require to commit to holding a long-term bond instead of a series of shorter-term bonds. For example, if the interest rate on the 10-year U.S. Treasury note is 1.5%, and the interest rate on the 1-year U.S. Treasury bill is expected to average about 0.5% over the next 10 years, then the term premium on the 10-year U.S. Treasury note would be 1% or 100 basis points.

[9]Monetary policy describes the management of a nation's money supply by the government or central bank. Tightening money supply is a course of action undertaken by a central bank to constrict spending in an economy that is seen to be growing too quickly or to curb inflation when it is rising too fast. The central bank does this by raising short-term interest rates through policy changes to the discount rate, increasing the cost of borrowing and effectively reducing its attractiveness.

About Pacific Asset Management

Founded in 2007, Pacific Asset Management specializes in credit-oriented fixed-income strategies. Pacific Asset Management is part of Pacific Life Fund Advisors LLC, an SEC-registered investment adviser and a wholly owned subsidiary of Pacific Life Insurance Company. As of June 30, 2016, the firm had total assets under management of approximately $5.4 billion.

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