



Below is the latest commentary from Pacific Life Fund Advisors, the investment advisor to the Pacific FundsSM.

“Reconciliation between what markets think and what the FOMC thinks will have to happen at some point. That’s a potentially violent reconciliation and I am concerned about that.”

– James Bullard, President and CEO of the Federal Reserve Bank of St. Louis

Somewhere to Hide

Examining Fixed-Income Allocations When Interest Rates (Finally) Start Rising

Experienced investors do not seek to time short-term market movements. Rather, they prepare to best navigate what long-term trends may come, without losing track of their investment objectives. With interest rates increasingly likely to begin rising due to Fed action, we examine the consensus view, look back at past tightening periods, and discuss how different fixed-income asset classes may perform in a rising interest rate environment.

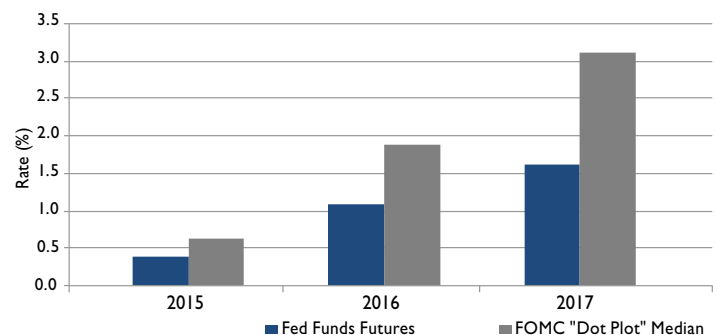
Complacency Persists

In October 2014, we posed what was at the time a somewhat controversial hypothesis—that the Federal Reserve was getting ready to tighten monetary policy. Market participants, gorging on abundant leverage and gulping down free-flowing liquidity, failed to notice the signs that their Vegas buffet was slowly being remodeled into an organic bodega. Consensus has since begun to shift, largely due to the ever-more-blunt language coming from the Fed. Still, investors continue to magnify any dovish undertones in Fed-speak, while downplaying the more hawkish sentiments. As seen in Figure 1, this is evident in the spread between the Fed funds futures and the Federal Open Market Committee’s (FOMC) own projections for the Fed funds rate. In the Fed’s own words at the March FOMC meeting, “Federal Reserve communications ... were perceived as slightly more accommodative than expected.”¹

Key Takeaways

- Complacent investors continue to downplay the Fed’s increasing hawkishness
- Examining past tightening periods can shed light on how asset classes might react in the current environment
- Core bond allocations can be underweighted, but not drastically reduced
- Leveraged loans and high yield may perform well if the U.S. economy remains strong
- Treasury Inflation Protected Securities (TIPS) appear unattractive over both the near and longer term

Figure 1: Fed Funds Futures and FOMC median projections



Source: Bloomberg, 3/31/2015. “Dot Plot” refers to a plot of federal funds rate point forecasts (dots) made by members of the FOMC.

¹Board of Governors of the Federal Reserve System. “Minutes of the Federal Open Market Committee.” *Federal Reserve*. March 17-18, 2015.

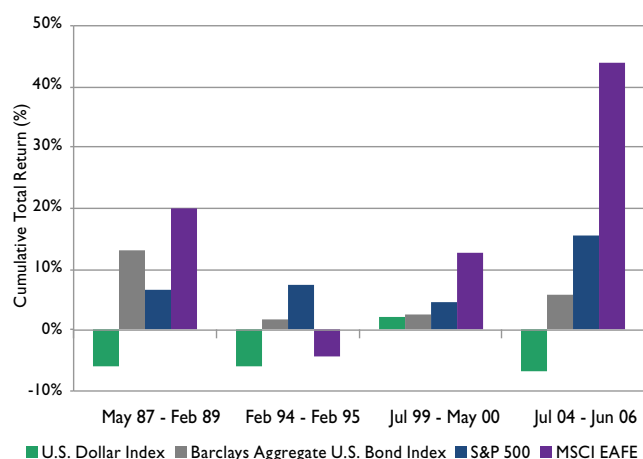


Many market commentators perceived Janet Yellen's recent comments, which noted that the Fed is cognizant of the negative effect that falling oil has been having on inflation and the rising dollar on exporters, as an indication that a rate hike isn't likely in the next few quarters. Regarding oil prices, the Fed minutes make it clear that the FOMC sees this as a short-term event, and therefore less relevant to their long-term objectives: "The staff's forecast for inflation in 2016 and 2017 was unchanged, as energy prices and non-oil import prices were still expected to bottom out and begin rising later this year."¹ So far as the dollar's recent runaway rally, which has indeed been hurting the U.S. economy, Fed tightening has either coincided with or caused greenback depreciation in three of the four periods that we've observed over the past 30 years. Given this confusion about the past, it seems appropriate to take a quick history lesson.

A Short History of Tightening

The Fed initiated a monetary tightening cycle four times in the past 30 years; from 1987 to 1989, 1994 to 1995, 1999 to 2000, and 2004 to 2006. The Fed typically tightens due to concern over rising inflation and/or an overheating economy. During these periods, the primary driver of a tightening cycle largely determined how global and domestic assets responded to the Fed's actions.

Figure 2: U.S. Dollar Depreciation During Periods of Tightening Fed Monetary Policy



Source: Morningstar, Bloomberg; 3/31/2015

In 1987, smaller government, lower taxes, deregulation of the stock market, and the rapid rise of the Japanese economy accelerated inflation well above the Fed's comfort level. The broad fixed income market fared well despite the Fed raising rates because long-term yields were already at elevated levels. Domestic equities, however, lagged their foreign counterparts as they were slower to recover from the Black Monday market crash of 1987.

Early in 1994, as the U.S. economy was emerging from a major recession, a sharp rebound in GDP growth and employment prompted long-term Treasury yields to rise. This caused the Fed to fear an imminent bout of inflation, even though the Consumer Price Index (CPI) had fallen over the previous 12 months. Trying to curtail that risk, the FOMC raised the Fed funds rate 3% from February 1994 through February 1995. This flattened the yield curve and hurt domestic bond performance. In contrast, this environment proved favorable for bank loans due to their floating rate nature. The economic recovery was gaining momentum and as a result corporations were able to bear the higher yield. Domestic stocks were likewise buoyed by the buoyant economy. Conversely, foreign stocks were sluggish over this period preceding the Asian Financial Crisis.

In the middle of the dot-com boom, from 1999 through 2000, GDP growth was rapidly accelerating and unemployment fell to 4%. The Fed decided to reign in the overheating economy and began to tighten. Domestic equities experienced moderate gains from the tech boom and the dollar appreciated, as foreign investors bought U.S. assets. Bonds also earned modest gains despite the rise in rates, since both short- and long-term yields were still above 5%.

In 2003, we saw another surge of growth in the U.S. but it was concern about inflation that motivated the Fed to raise rates. Domestic equities remained stable, supported by the recovering U.S. economy. Within fixed income, bank loans again outperformed the broader debt markets as short-term rates rose faster than long-term rates.

¹Board of Governors of the Federal Reserve System. "Minutes of the Federal Open Market Committee." *Federal Reserve*. March 17-18, 2015.



Current market conditions exhibit fragments of these previous periods. Domestic equities have experienced double-digit returns in five of the past six calendar years, rising over 250% since the trough of the financial crisis. U.S. economic growth is robust, and the Fed is beginning to grow concerned about the long-term rate of inflation. Meanwhile, after trailing the U.S. economic recovery, European and Japanese economies are being given an extra-strength boost of accommodative policy by their central banks. This divergence in central bank policies – with the U.S. starting to tighten while other nations are easing – occurred from 1986 to 1988 as well. It is worth noting that during that period, the MSCI EAFE Index of international equities outpaced the S&P 500 by a wide margin.

Allocating Within Fixed Income

Having established that we are likely at the doorstep of what James Bullard called a “new era of monetary policy²”, investors may wish to examine how best to position the fixed-income portions of their portfolios for what lies ahead.

Investment-grade corporate and Treasury debt, which we refer to as core bonds, tend to underperform other pockets of fixed income during periods of tighter monetary policy, given their generally pronounced interest rate risk. Despite this, it would be brash to outright abandon these traditional investments. First, investors currently overexposed to equities, and responsible for much of the narrow market conditions we have recently experienced, may get spooked by the announcement of the first few rate hikes. This may cause them to swap risky stocks for safer bonds (in the sort of flight to quality we’ve already experienced many times throughout the aftermath of the financial crisis). Second, and more importantly, we must consider the overall trajectory for interest rates in this new era. While the Fed is expected to begin raising rates this year, they are not likely to do so quickly or drastically, as San Francisco Fed President John Williams noted that interest rates will not get to the peaks we’ve seen historically³. This is further substantiated by the longer-term “neutral rate” for Fed funds remaining at 3.75% since the June 2014 meeting⁴. This is the rate that the FOMC believes will keep both inflation and

unemployment rates at their target levels. To summarize, while we see more attractive sectors within fixed income in the current environment, we also don’t believe core bonds will lag so severely as to merit a *drastic* reduction.

Perhaps the most logical fixed-income asset class to overweight against core bonds during a tightening episode is bank loans. Investors who bought leveraged loans, as bank loans are often called, in previous tightening periods would have earned an average spread of 4.5% over core bonds⁵. The reason for loans’ outperformance lies in their structure floating rate coupons that reset at predetermined intervals allow them to adjust along with short-term interest rate movements. While loans tend to be both senior to other debt and secured by the borrower’s assets, they are primarily utilized by companies with below investment-grade credit ratings. Hence, a greater default risk during trying times is the tradeoff for higher expected returns. Since the Fed would be raising rates because of a stable and improving economic outlook, the risk that borrowers would fail to meet their obligations appears lessened, especially if history can be trusted.

Given a favorable outlook on the broad U.S. economy, high yield debt is another fixed-income asset class to consider. High yield bonds are considered a more equity-like fixed income asset class, and they have indeed been riding on equity’s coattails until the fourth quarter of 2014. This decoupling (as illustrated in Figure 3) makes high yield appear more fairly valued than stocks and less likely to experience a further drawdown when the Fed raises rates, although it is possible we’ll see a temporary lift in volatility when the first rate hike is finally announced. Another advantage of the high yield sector in the current environment is that it tends to be comprised of smaller companies that generate most of their sales domestically. High yield issuers are thus more shielded from a stronger dollar than large cap equities that derive significant revenue from exports. Compared to investment-grade bonds, high yield bonds have a shorter duration (i.e. less interest rate sensitivity) and should consequently perform better when yields start rising.

²BloombergBusiness. “Bullard Says Removal of ‘Patience’ Marks New Fed Era”, Bloomberg L.P., March 24, 2015.

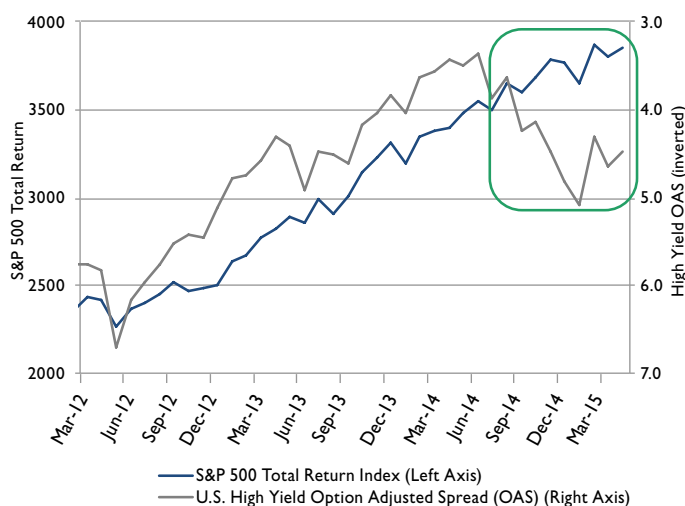
³Lee, Don. “San Francisco Fed President John Williams expects momentum in labor market.” *Los Angeles Times*. March 26, 2015.

⁴Source: Bloomberg, March 2015.

⁵Source: Barclays and Credit Suisse, March 2015.



Figure 3: The Decoupling of High Yield and Equities



Source: Bloomberg, 3/31/2015.

It should be noted, however, that as is the case with leveraged loans, default risk is of primary concern when investing in high yield bonds. In fact, it is amplified given that high yield debt is generally more junior in the capital structure than a bank loan. Moreover, as we mentioned in previous discussions on the impact of falling oil prices, about 16%⁶ of the high yield universe is comprised of energy firms. To minimize these risks, it is crucial to pick a high yield manager that does rigorous bottom-up analysis and invests in companies with strong and improving fundamentals that can weather shocks to liquidity and their industry.

It may initially appear intuitive to load up on TIPS, given that the Fed is raising rates in order to keep inflation at bay. However, we believe this would be misguided. While TIPS have typically done well during rate hikes, the current environment is unique. First, outside the U.S., developed markets are mired in deflation. The way that both Japanese and European central banks are fighting deflation is by effectively exporting it to the U.S. This has been a major cause of the dollar's recent rally. Second, the premise behind the Fed's tightening policy would be to take advantage of the strong economy to head off inflation before it becomes an issue. In other words, both the near- and long-term prospects for TIPS appear questionable.

It is evident that when there is a major event on the horizon, such as impending change in monetary policy, investors benefit by looking to the past and analyzing the present in order to craft a blueprint for the future⁷. Taking positions that best align the potential risks and rewards with long-term objectives and staying calm through passing turbulence should serve you and your portfolio well.

⁶Source: Bloomberg, March 2015.

⁷Past performance does not guarantee future results.



Fed Tightening Periods refer to monetary policy actions aimed to manage economic growth to a sustainable pace and curb inflation. Central banks typically enforce tight monetary policies by effectively raising short-term interest rates (i.e. Fed funds rate) through a reduction of the supply of money in the system.

The U.S. Dollar Index indicates the general international value of the USD. The USDX does this by averaging the exchange rates between the USD and major world currencies. The Intercontinental Exchange computes this by using the rates supplied by some 500 banks.

The Barclays U.S. Aggregate Bond Index is composed of approximately 7,000 asset-based, corporate, government, and mortgage-backed bonds.

The S&P 500 Index is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. S&P 500 is a registered trademark of Standard & Poor's Financial Services LLC.

The MSCI EAFE Index is an equity index which captures large and mid cap representation across Developed Markets countries around the world, excluding the US and Canada. With 910 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

U.S. High-Yield is based on the **Barclays U.S. High-Yield Index**, which covers the universe of fixed rate, non-investment-grade debt.

About Pacific Life Fund Advisors

Established in 2007, Pacific Life Fund Advisors LLC (PLFA) provides multi-asset and balanced allocation solutions through its asset allocation, manager research, and investment risk management functionalities. PLFA is an SEC-registered investment adviser and a wholly owned subsidiary of Pacific Life Insurance Company (Pacific Life). As of March 31, 2015, PLFA managed approximately \$43 billion in total assets.

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All investing involves risk, including the possible loss of the principal amount invested.

You should consider a fund's investment goal, risks, charges and expenses carefully before investing. The prospectus and, if available, the summary prospectus contain this and other information about the fund and are available from your financial advisor or www.PacificFunds.com. The prospectus and/or summary prospectus should be read carefully before investing.

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Effective December 31, 2014, Pacific Life Funds and its family of mutual funds changed its name to Pacific Funds. In addition, individual funds were also renamed. For more information, please visit www.PacificFunds.com.

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5 of 5

