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

Breaking Up with ZIRP Is Hard to Do

The decision in September by the Federal Reserve (the Fed) to not raise the federal funds (fed funds) target rate highlights the challenges of U.S. monetary policy given weakening global growth and financial markets. In this article we discuss the Fed's September decision, outlook for Fed policy, and implications for capital markets.

The Global Central Bank

Citing the potential drag from global economic and financial developments, the Fed maintained its Zero Interest Rate Policy (ZIRP) at its meeting on September 17. In making this decision, members of the Federal Open Market Committee (FOMC) noted the need to monitor "developments abroad" along with concerns of inflation remaining below 2% as reasons for inaction. The FOMC members also reduced their short-term outlook for growth and inflation, implying that global factors will continue to weigh on the U.S. economy (Table 1). The FOMC members went further by revising downward the potential path of rate hikes via the "dot plots" (Chart 1). On average, the committee now sees a 1.125% fed funds rate by year-end 2016, implying three hikes versus the four forecasted prior to the September meeting.

Table 1: The Fed reduces its growth and inflation outlook

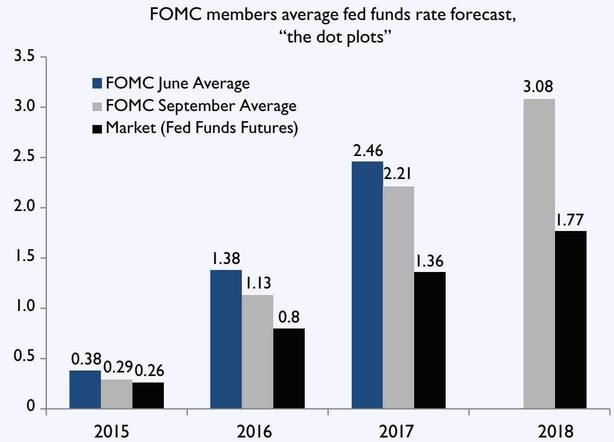
FOMC Median Forecast	2015	2016	2017	2018
Real Gross Domestic Product (GDP) Growth (%)				
September 2015	2.1	2.3	2.2	2.0
June 2015	1.9	2.5	2.3	N/A
Unemployment Rate (%)				
September 2015	5.0	4.8	4.8	4.8
June 2015	5.3	5.1	5.0	N/A
Core Personal Consumption Expenditures (PCE) Inflation (%)				
September 2015	1.4	1.7	1.9	2.0
June 2015	1.3	1.8	2.0	N/A

Source: Federal Reserve, as of September 17, 2015.

Lower and Slower

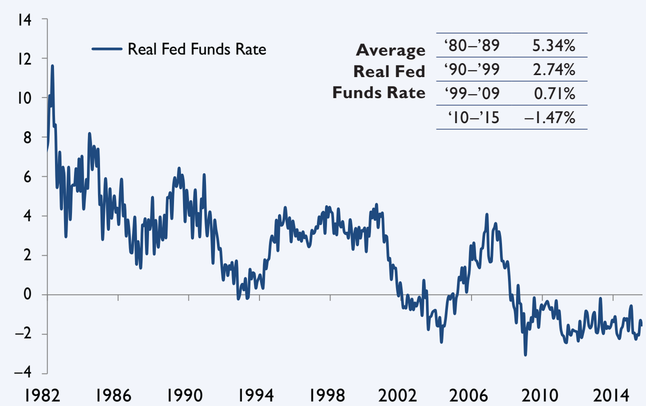
Whether or not the Fed decides to raise the fed funds target rate in 2015, forecasts for the pace of tightening and terminal levels suggest lower and slower.

FOMC forecast of the fed funds target rate was adjusted lower as global economic concerns were factored in



Source: Federal Reserve, as of September 17, 2015.

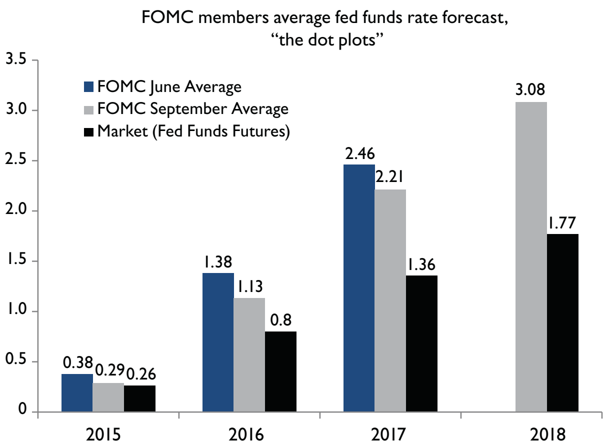
Declining inflation and weak demand constrain what a neutral fed funds target rate may be



Source: St. Louis Federal Reserve, as of August 1, 2015.

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

Chart 1: Average fed funds forecasts from FOMC members were reduced in September

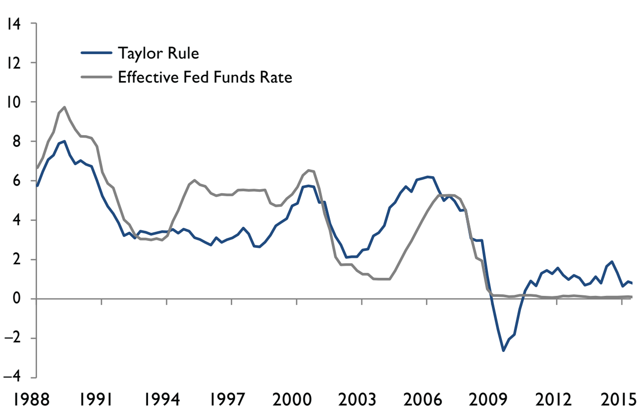


Source: Federal Reserve, as of September 17, 2015.

Fed Policy: Even Lower and Slower

The Fed's decision to leave rates unchanged highlights the challenges faced by central bankers in exiting policies of the post Great Recession environment. The U.S. economy continues to grow at a below-trend pace, while increasing global economic risks have weakened growth and inflation outlooks. While Federal Reserve Board Chair Janet Yellen continues to express in her forward guidance that a rate hike before year-end 2015 is likely, the weakness in financial markets may continue to provide reason for pause. In contrast to historical periods coinciding with the start of Fed tightening cycles, it can be easily argued that current economic growth is weak.

Chart 2: Taylor rule continues to warrant a very low fed funds target rate



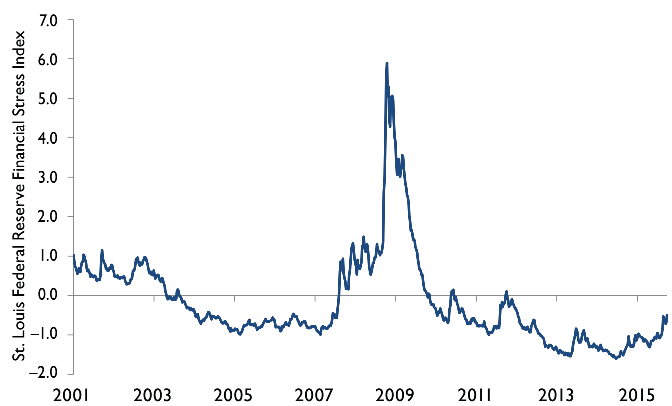
Source: St. Louis Federal Reserve, as of July 1, 2015.

One common yardstick for the fed funds target rate is the Taylor rule, which provides an estimate of a neutral rate based on the output gap and current inflation. The Taylor rule currently estimates a neutral target rate to be approximately 1–2% (Chart 2). When incorporating a risk premium due to global growth concerns, the past few months have only reinforced the limited path of policy tightening currently available to the Fed.

A De Facto Tightening?

In many ways, current market conditions suggest a tightening has already occurred, without any action from the Fed. Lower equity prices, wider credit spreads, shelving of new issuance, and a strengthening U.S. dollar have all acted as a de facto tightening of monetary conditions. The Fed has acknowledged in its forward guidance the impacts of these tighter financial conditions prior to the start of tightening.

Chart 3: Financial stress has increased over the past few months leading to a de facto tightening of monetary conditions



Source: St. Louis Federal Reserve, as of September 30, 2015. The index measures the degree of financial stress in the markets and is constructed from 18 weekly data series: seven interest-rate series, six yield spreads, and other indicators.

Chart 4: Wider credit spreads in high yield over the past year have acted as a phantom rate hike for leveraged borrowers

Source: Barclays, as of September 30, 2015.

Whether or not the Fed decides to raise the fed funds target rate in fourth quarter 2015 or early 2016, we expect a continuing environment of tepid U.S. growth, benign inflation, increasing global economic risks, and tighter monetary conditions. The shortfall in output and inflation will remain a defining feature of the U.S. and global economic landscape. These conditions have resulted in accommodative monetary policy for years beyond investor expectations. Going forward, these conditions will most likely result in a terminal, fed funds target rate of 1–2%, rather than historical suggestions of 4%.

The reality is that the Fed is only one actor on a broader stage determining U.S. Treasury yields and monetary conditions. Global central bank policies, global risks, and a multitude of economic factors are playing an important role in monetary conditions. Treasury yields are currently among the highest of the G-10 (a group of large developed countries), driving capital flows and weighing down yields of intermediate and longer-maturity bonds. As former Federal Reserve Board Chairman Ben Bernanke recently commented on his blog at the Brookings Institution,

"Real interest rates are determined by a wide range of economic factors, including prospects for economic growth–not the Fed."

Our Bottom Line

The past few months have reinforced a few important themes for us. First, global sovereign and U.S. Treasury yields may remain low for a considerable period. Second, market volatility should continue during the next several quarters as diverging central bank policies and fundamentally driven growth and sector risks increase. Third, poor liquidity conditions in secondary markets will result in increasing distortions, which should be advantageous to smaller asset managers who can execute views. Lastly, and of particular importance for active management, security selection is paramount in driving returns during these stages as the business, credit, and monetary policy cycles are more divergent. Opportunities should be most available to those who have the ability to be truly selective in portfolios.

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Barclays High Yield Index refers to the Barclays U.S. High-Yield Index, which covers the universe of fixed rate, non-investment-grade debt.

Terminal level or terminal rate is the rate at which the Fed will end the next hiking cycle.

About Pacific Asset Management

Founded in 2007, Pacific Asset Management specializes in credit-oriented fixed-income strategies. Pacific Asset Management is a division of Pacific Life Fund Advisors LLC, an SEC-registered investment adviser and a wholly owned subsidiary of Pacific Life Insurance Company (Pacific Life). As of September 30, 2015, Pacific Asset Management managed approximately $5.59 billion. Assets managed by Pacific Asset Management include assets managed at Pacific Life by the investment professionals of Pacific Asset Management.

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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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