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

Portfolio Manager Viewpoint - Credit Markets

The post-U.S. presidential election environment has seen a sharp rally in risk assets and economic optimism. In this note, David Weismiller, portfolio manager for Pacific Asset Management's investment-grade bond strategies, discusses the market environment and current investment positioning.

The market has changed; discuss the post-election environment.

Weismiller: Prior to the election, we felt the economy and corporate earnings were gaining momentum. Since the election, expectations of fiscal stimulus, tax reform, and regulatory rollbacks have improved sentiment. This optimism, along with improved economic and earnings outlooks, have been major catalysts driving risk assets higher (Table 1). With markets pricing in a lot of positive news, the short-term driver of market performance most likely will be whether sentiment is validated by policy action.

Table 1: Risk assets continue to lead

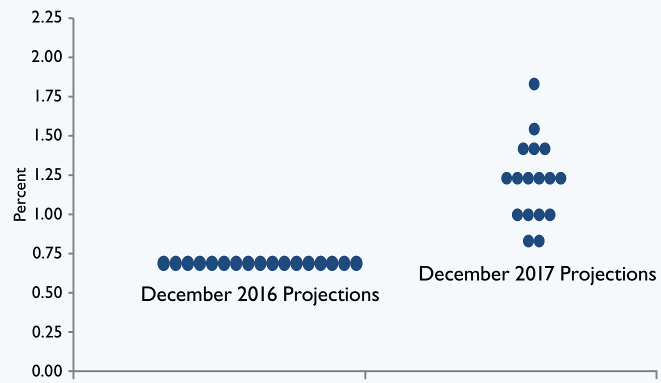
Index	Returns Since 11/8 (%)	1-Year Return (%)
S&P 500®	11.12	18.27
High Yield	3.75	16.05
Bank Loans	2.74	9.73
Intermediate Corporate	–0.47	2.89
Corporate	–0.72	3.80
Agency MBS	–1.42	0.34
Aggregate	–1.44	0.81
Treasury	–2.08	–1.05

Source: Bloomberg Barclays, Credit Suisse, as of March 28, 2017.

Curve Flattening

Despite expectations for the fed to raise the target rate 2-3 times in 2017...

Federal Reserve "Dot Plots" for 2017



Source: Federal Open Market Committee (FOMC), as of March 15, 2017.

Long-term U.S. Treasury yields have been largely range bound since November 2016

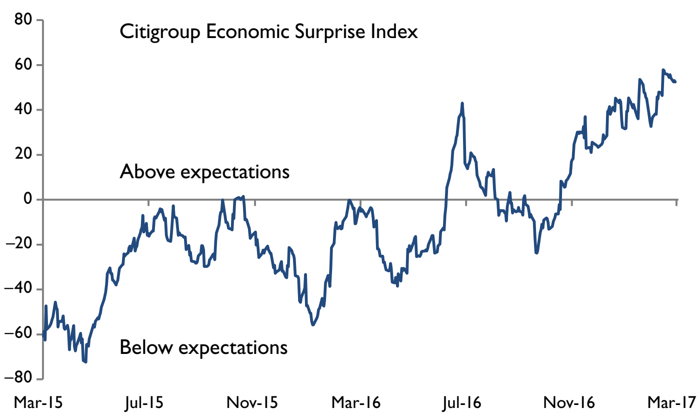
Source: Bloomberg Barclays, as of March 31, 2017.

Performance data quoted represents past performance, which does not guarantee future results. Current performance may be lower or higher than the performance quoted. Indexes are unmanaged and cannot be invested in directly. Further, they hold no cash and incur no expenses.

How do you assess the economic outlook? Are we poised for a sharp upturn in gross domestic product (GDP)?

Weismiller: Our outlook on the U.S. economy and corporate earnings is much improved from last year. While economic benefits from policy changes may take some time, consumer and business sentiment measures have reached 15-year highs (Chart 1). Sentiment can be self-fulfilling as companies pull demand forward in anticipation of higher growth and become more comfortable putting capital to work (i.e., capital expenditures). While we don't anticipate a sharp upturn in GDP, we expect continued positive economic momentum as supported by what we're seeing in the new-orders index, hiring surveys, and the Institute for Supply Management® (ISM) Manufacturing Index.

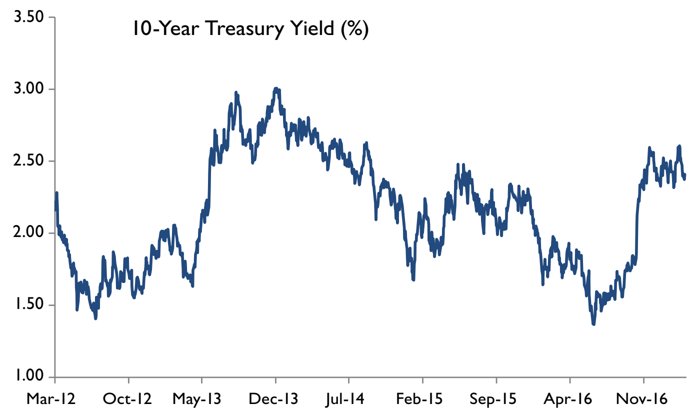
Chart 1: Improving economic data has supported risk assets since mid-2016



Source: Bloomberg, as of March 27, 2017.

While the yield curve may be a bit distorted by monetary policy, longer-maturity Treasuries are a key forward-looking indicator of growth and inflation. Following the election in November, Treasury yields surged, given the renewed growth and inflation expectations (Chart 2). However, since the initial adjustment to a year-end yield of 2.43%, the 10-year Treasury yield has been range-bound. This is despite improving economic data, increasing inflation measures, and a rate hike from the U.S. Federal Reserve (Fed). To us, this translates to a bond market that is cautious on an acceleration of growth and the ability of the new administration to achieve all the regulatory and fiscal-policy goals.

Chart 2: Treasury yields have been range-bound after the November election spike



Source: Bloomberg Barclays, as of March 28, 2017.

What is your outlook for monetary policy?

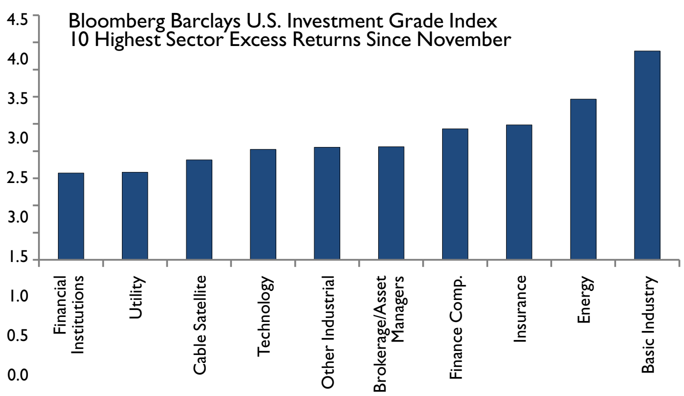
Weismiller: After two years of "one and done" in December, the Fed raised the fed funds target rate by 25 basis points (one basis point equals 0.01%) in March and signaled two more hikes in 2017. Although we believe two more rate hikes may be warranted this year, the Fed may err on the cautious side of this projection. I believe it will continue to be data-dependent and not try to front-run expected fiscal policy. Post-2017, I think it's doubtful the Fed will be able to move in line with the projected hikes in 2018 and 2019.

For the markets, this means that as the Fed tightens policy, short-term rates should steadily move higher, and volatility in long-term rates may pick up. As the Fed shifts away from monetary stimulus, fiscal stimulus is expected to fill some gaps. However, headwinds for long-term growth, including shifting demographics, eurozone instability, and broadly restrictive banking regulation, should remain. I also expect the positive technicals for longer-term assets from foreign purchasers and defined benefit plans to continue. So while the Fed will begin its road toward normalizing its policy, the aforementioned factors should help keep a bit of a lid on long-term rates.

Let's narrow in on U.S. credit. What has been the market performance post-election?

Weismiller: Corporate bonds have benefited from the favorable fundamental and technical backdrop, exhibiting strong excess returns over Treasuries and other government-related asset classes (Chart 3). The rotation in sector leadership has been toward companies viewed to benefit more from the new administration's focus on deregulation; the Energy, Metals and Mining, Banks, and Financials sectors have seen meaningful excess returns. Additionally, many capital goods and industrial sectors that may benefit from fiscal stimulus and infrastructure spending have also performed well, while more interest-rate sensitive sectors have underperformed.

Chart 3: Corporate sectors with highest excess returns since November 2016



Source: Bloomberg Barclays, incorporates the five-month trailing period ending March 27, 2016. Basic Industry includes the Metals and Mining sector.

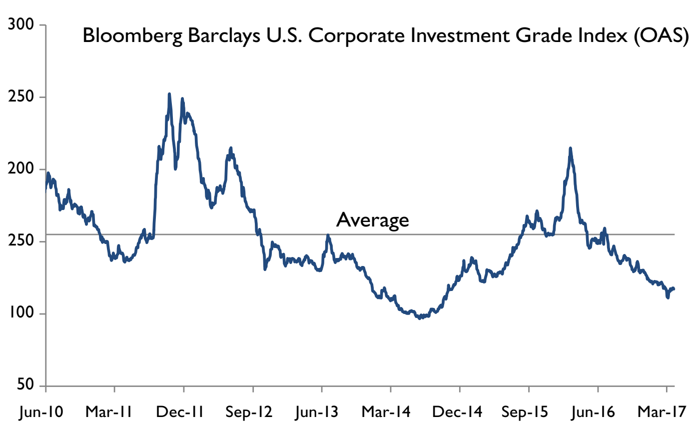
Assess the current fundamental, technical, and valuation environment for U.S. credit.

Weismiller: Investment-grade companies are currently running with historically high levels of leverage. This has been the result of two main factors: 1) cyclical sectors such as Energy and Metals and Mining entering earnings troughs and 2) increased debt-funded merger and acquisition (M&A) during the past two years as the combination of low growth and borrowing costs fuel corporate-debt issuance. Despite this, a better picture of corporate health is emerging. Earnings growth in the Energy and Metals and Mining sectors is helping these companies to reduce leverage. Also, corporate M&A activity has slowed, and we have witnessed management teams paying down debt after their respective M&A combinations. Away from the balance sheet, corporate cash flows and liquidity levels remain robust.

From a technical perspective, the significant demand for U.S. corporate bonds has provided a favorable tailwind. With negative interest-rate policies abroad and systemic risks in Europe, U.S. credit has seen record-setting demand during the past few years. We believe this will continue.

From a valuation framework, after the strong move lower over the past few months, option-adjusted spread (OAS) levels are toward the tights of the post-2009 range (Chart 4). This leads us to focus on higher-quality credits and companies that are able to execute on their de-leveraging plans. Should interest rates move higher, investors have some insulation due to the incremental spread from these issues.

Chart 4: Corporate bond spreads have moved toward the lower end of the post-crisis cycle



Source: Bloomberg Barclays, as of March 27, 2017.

Describe your current positioning.

Weismiller: From a top-down perspective, the landscape looks accommodating for our corporate issuers, and we are broadly in-line with benchmarks on an OAS basis, given current valuations. We believe BBB-rated corporate bonds provide the greatest risk/reward in investment-grade fixed income. Thus, we continue to be overweight, but remain selective.

Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).

There are a few important themes in our strategies. We are focused on U.S. companies with domestic revenue streams given a favorable outlook on U.S. growth. Since the election, our conviction around "staying home" in terms of corporate profits continues to strengthen, especially given potential tax cuts, repatriation, and uncertain trade policies, all combining for a more favorable U.S. economic cycle.

We have been, and continue to be, overweight U.S. banks and financials and, while we have reduced that overweight post-election, find them as attractive core holdings. This view is in contrast to eurozone bank counterparts, and we find many to have unattractive valuations and margins of safety, given systemic concerns. We are underweight sectors that continue to see shareholder-friendly activity and M&A, which pose a risk to bond holders. We find this most relevant in the Healthcare and Technology sectors, where industry-wide consolidations and releveraging are taking place.

For strategies that incorporate non-investment-grade sectors, we find bank loans to have risk-adjusted relative value when compared to high yield. While yields for BB-rated and B-rated securities are near equivalent for the two asset classes, the limited-duration risk and lower volatility of bank loans is currently attractive.

You didn't mention retail.

Weismiller: Retail will have a lot of headlines this year and in the future as there may be quite a few brand names either stripped of their investment-grade rating or even restructured through bankruptcy. While the Retailers sector accounts for only around 4% of the Bloomberg Barclays U.S. Corporate Investment Grade Index, the heightened media attention and name recognition will put this top of mind for many investors. We have had significant underweights to many of the brand-name retailers because of their secular headwinds, likelihood of downgrades, and ongoing stress on their balance sheets. Many management teams will find themselves choosing between supporting their strong credit ratings or their stock prices. Despite our negative outlook, we have found value in a few organically growing credits in the specialty, discount, and drugstore spaces.

Summarize the outlook and investment positioning.

Weismiller: Improving economic data and the prospects for fiscal stimulus, tax reform, and less regulation have led to excess returns for corporate credit to start 2017. Given stable corporate health and economic data, we expect these positive returns to continue in the short term. While spreads have compressed, the relative-yield advantage provided by corporate bonds remains favorable in our view and should help protect investors against rising interest rates relative to government-related securities. While we are finding value in select sectors and individual credits, current valuations leave us leaning slightly defensive.

Agency Mortgage-Backed Securities (Agency MBS) is represented by the Bloomberg Barclays Mortgage-Backed Securities Index, which is a market value-weighted index composed of agency mortgage-backed pass-through securities of the Government National Mortgage Association (GNMA, and called Ginnie Mae), the Federal National Mortgage Association (FNMA, and called Fannie Mae), and the Federal Home Loan Mortgage Corporation (FHLMC, and called Freddie Mac) with a minimum $150 million par amount outstanding and a weighted-average maturity of at least one-year.

Aggregate is represented by the Bloomberg Barclays U.S. Aggregate Bond Index, which is composed of investment-grade U.S. government and corporate bonds, mortgage pass-through securities, and asset-backed securities, and is commonly used to track the performance of U.S. investment-grade bonds.

Bank Loans are represented by the Credit Suisse Leveraged Loan Index, which is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market.

The **Citigroup Economic Surprise Index** measures the actual outcome of economic data releases relative to consensus estimates, defined as weighted, historical standard deviations of data surprises.

Corporate is represented by the Bloomberg Barclays U.S. Corporate Investment Grade Index, which includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

High Yield is represented by the Bloomberg Barclays U.S. Corporate High-Yield Index, which covers the universe of fixed-rate, non-investment-grade debt.

Intermediate Corporate is represented by the Bloomberg Barclays U.S. Intermediate Corporate Bond Index, which is the intermediate component of the Bloomberg Barclays U.S. Corporate Investment Grade Bond Index.

The **S&P 500® index** is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the U.S. stock market.

Treasury is represented by the Bloomberg Barclays U.S. Treasury Index, which includes public obligations of the U.S. Treasury.

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. As of March 31, 2017, Pacific Asset Management managed approximately $6.2 billion in assets. Assets managed by Pacific Asset Management include assets managed at Pacific Life by the investment professionals of Pacific Asset Management.

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