Below is the latest informational commentary from Pacific Life Fund Advisors LLC, the investment adviser to Pacific Funds[SM].

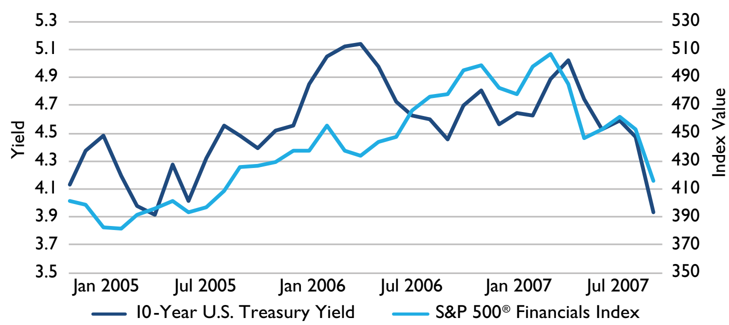
2017 Outlook: The Picture Taking Shape

Like a painter who puts a brush to the canvas with only a desire to explore, the first brushstrokes of 2017 have shown promise, even if we cannot yet see the whole picture taking shape. These strokes sketch a landscape more favorable for businesses and growth, while details are sparse and up for interpretation. In this article, the Investment Committee at Pacific Life Fund Advisors shares what it sees as the initial outlines and how they frame the likely picture for 2017.

U.S. Equities

The markets in the U.S. are likely to be pulled in conflicting directions during 2017, dominated by two main themes. First, the president's focus on generating economic growth through fiscal stimulus, tax reform, and deregulation should buoy domestic stocks, even though they have already run up since the election in anticipation of these policies. The economy is already near its optimal capacity, justifying its somewhat sluggish growth rate. Many factors, including the unemployment rate, stock valuations, and the rate of share buy-backs, are indicative of late-cycle dynamics, which imply increased odds of a slowdown on the horizon. On balance, we feel that the push for economic growth will extend economic expansion further and likely lead to continued appreciation for U.S. equities during the next several years, with the cost being a longer and deeper recession down the line. We see these opposing factors leading to two main implications: the favoring of value stocks over growth stocks, and of mid-cap stocks over large- and small-cap stocks. The preference for value stocks stems primarily from impacts on two value-heavy sectors: namely, Energy and Financials. Fiscal stimulus should cause inflation to rise and that, in turn, would likely lead to higher interest rates as the Federal Reserve (Fed) would look to keep inflation in check. Higher interest rates benefit financials by improving net interest margin, especially if the yield curve steepens. The most recent example of the link between financials and higher interest rates occurred in 2006 to 2007, and can be seen in Figure 1, which shows the 10-year U.S. Treasury yield alongside the S&P® Financials Index.

Figure 1: U.S. Financials Rally with Rising Yields

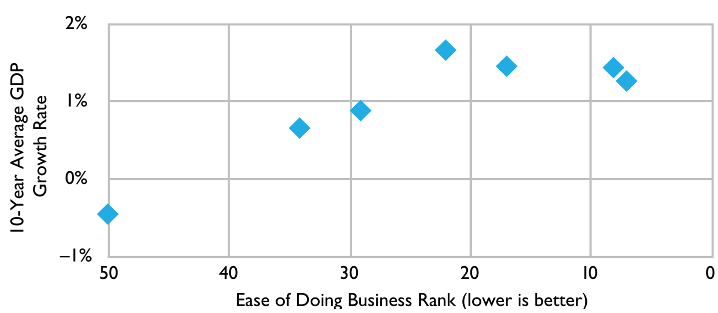


Source: Bloomberg.

Meanwhile, deregulation could benefit both energy and financial companies, which are two heavily regulated industries. Over-regulation can make it more difficult to do business, which can hinder economic growth. Figure 2 plots the G7[1] countries by their ease of doing business against their 10-year average gross domestic product (GDP) growth rate. Countries with a better ease of doing business ranking tend to have less-extensive and complex regulation and consequently tend to have higher rates of growth. Energy companies may also benefit from a stabilization of oil prices as agreements for output cuts are holding between OPEC countries and Russia, and the previous oil-price drop has forced U.S. shale producers to become much more efficient and capable of survival at lower prices. Together, these factors provide a significant tailwind for value stocks over growth stocks in 2017.

Figure 2: Better Business Climates Foster Growth

GDP Growth and Ease of Doing Business Ranking for G7 Countries



Source: World Bank, Bloomberg, June 2016.

[1]The member states of the G7 are the United States, United Kingdom, France, Canada, Italy, Japan, and Germany. "Data from the Doing Business Project." Doing Business Data. The World Bank Group, February 2017.

Mid-cap stocks may be favored over small- and large-cap stocks due to the stronger U.S. dollar, potentially lower corporate taxes, and deregulation.

First, a potentially stronger dollar from rising interest rates would lead to more expensive exports, which reduces overseas demand for U.S. goods. Revenues generated overseas would also be smaller once converted back into dollars, reducing the top line for large multinationals. Additionally, protectionist trade policies and treaty renegotiations may have adverse effects on larger firms with operations spread across the globe.

Second, larger firms typically benefit from lower tax rates overseas and therefore have a lower effective tax rate than smaller firms. As a result, small- and mid-cap stocks would benefit more from potential corporate tax cuts, leveling the playing field with larger and more global firms. However, small-cap stocks have already enjoyed a very strong bounce since the U.S. presidential election, making their valuations more stretched. Mid-cap firms in the U.S. did not rally as much in the post-election run up and they export less, generate less revenue overseas, and have a smaller international footprint than larger multinationals, putting them in somewhat of a "sweet spot."

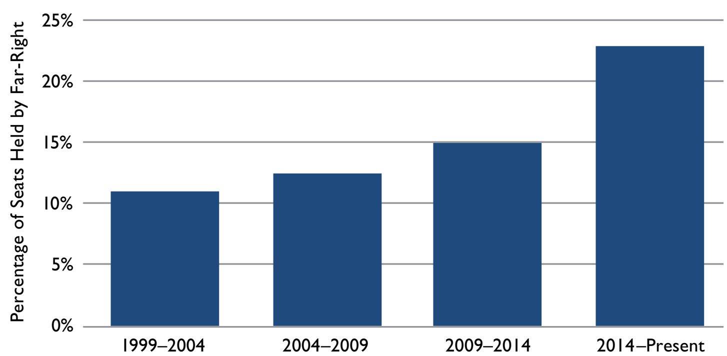
Third, the possibility of deregulation could potentially help midsize firms that do not have the scale to cost-effectively maintain compliance, and it could help them close the gap with larger firms, providing a relative tailwind to mid-cap stocks.

International

The outlook for developed international stocks centers on the economic recoveries of Europe and Japan and the potential challenges presented by rising populist movements, especially in Europe. The eurozone and Japan are both still heavily supported by their respective central banks, with the European Central Bank (ECB) still implementing negative interest rates, and the Bank of Japan (BOJ) continuing its policies to backstop the yield on government bonds and buy equities.

The eurozone is showing signs of recovery, with falling unemployment and signs of increasing inflation. Japan also shows signs of rising inflation and economic output, though the government has had to delay planned tax increases, underscoring a stark difference with a U.S. policy that appears to be heading toward lower taxation. Overall, the uptick in output from developed international stocks suggests they are continuing on their recovery trajectory, and they do so with lower valuations than we see in the U.S.

Figure 3: The Growth of Populism in Europe
Parliamentary Seats Held by Far-Right Parties



Source: Rosa Luxemburg Foundation, February 2016.

Significant headwinds remain, however. The existence of the European Union (EU) is under threat as nationalist movements continue to gain seats in governments throughout the trading bloc. Figure 3 shows the expanded presence of far-right populist groups within the EU, growing from just over a 10% share of seats in the early 2000s, to nearly a quarter during the last few years. And one commonality shared among these groups in various countries is a rising call to separate from the EU.

The U.K. demonstrated that this action is indeed a real possibility as per the vote in June 2016 to leave the EU, yet the full economic repercussions of "Brexit" have not yet been felt. Both France and Germany face elections this year, and the continued bailouts of periphery countries like Greece along with slow growth and high unemployment have all fueled the surge in populist supporters.

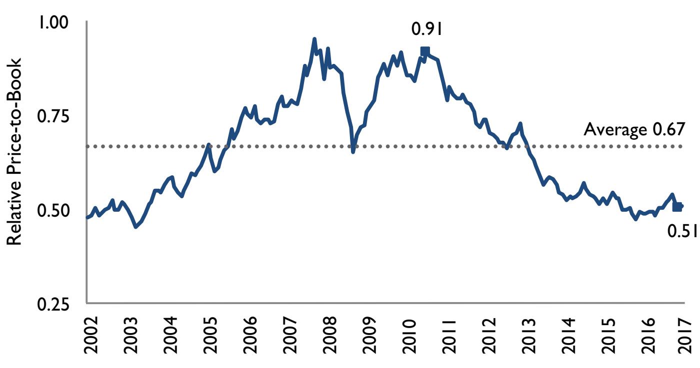
The breakup of the EU would likely hurt international trade and global economic output as new treaties would need to be negotiated, and companies would likely cut back on spending and potentially relocate in anticipation of slowing growth or contraction. These implications counterbalance the more promising signs of growth and therefore slightly favor U.S. over developed international stocks, especially as any further appreciation in U.S. currency would hurt unhedged U.S. investor returns in international stocks.

Emerging Markets

Three themes dominate the outlook for emerging markets in 2017: global growth, commodity stabilization, and potential trade conflict. When it comes to valuations, we can see from Figure 4 that emerging-market stocks are as cheap as they have been in 15 years relative to the U.S. on a price-to-book basis.

Moreover, global growth is set to expand in 2017, providing a positive backdrop for emerging markets. The world's second-largest economy, China, has been transitioning from a manufacturing-oriented export economy toward a service-oriented economy more common in developed nations, and this gradual transformation had previously led to contraction of its manufacturing sector. However, manufacturing output in China and the emerging markets overall has been expanding again since July 2016. China is also investing in the New Silk Road, expanding infrastructure and deepening trade ties with other emerging economies such as Pakistan and India. The U.S. withdrawal from the proposed Trans-Pacific Partnership also gives China expanded influence as it is now the orchestrator of the only multilateral trade agreement in the region. Additionally, the New Silk Road should help insulate emerging markets from the potential ills affecting developed nations.

Figure 4: Emerging-Market Valuations Near Lows vs. U.S.

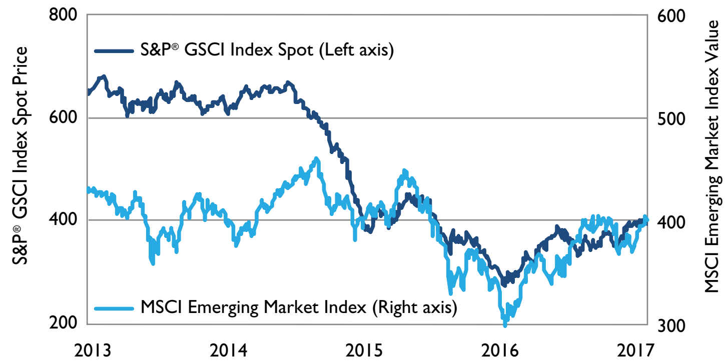


Source: FactSet, January 2017.

The drop in commodity prices beginning in late 2014 was a major catalyst for falling emerging-market equities in 2014 and 2015. We can see broad stabilization evident in Figure 5, with an agreed-upon oil production cut between OPEC countries and Russia, and many other industrial inputs and agricultural goods saw rebounds from their prior-year declines.

We can also see that bottoming occurred at the same time for commodities and emerging markets in early 2016. Expansion of global growth and the potential for infrastructure spending in the U.S. should continue to support greater demand for raw-material exports from emerging markets. This stabilization removes a significant headwind for emerging economies, especially for those that are heavy exporters of commodities.

Figure 5: Commodity Stabilization



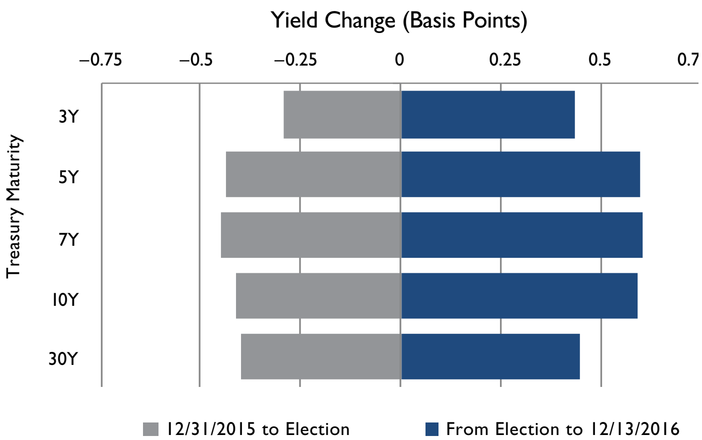
Source: Bloomberg, January 2017.

One potential counterbalance to the two more positive themes is the increased potential for trade conflicts. President Trump has postured with his Mexican counterpart, President Enrique Peña Nieto, over renegotiation of the North American Free Trade Agreement (NAFTA) and has spoken of labeling China a currency manipulator, both of which reflect heightening trade tensions. If negotiations break down, countries may resort to retaliatory trade tariffs, which harm the very consumers they are designed to protect. We see the threat of tariffs more as a crude negotiating tactic and not the likely eventual outcome. All sides have strong incentives to reach agreements that avoid hampering both their exporters and their import-consuming residents. We will be watching negotiations closely, but feel that the positive factors mentioned above favor emerging markets overall in 2017.

Fixed Income

Fixed income in 2017 will hinge on two main factors: the Fed and the credit cycle. The Fed is facing a narrow set of policy options as it attempts to normalize interest rates from post-crisis lows. With the labor market near full employment and the potential for pro-growth policies such as infrastructure spending and tax cuts, the stage is set for a return to inflation above the Fed's 2% target, and consequently a return to rising interest rates. We can actually see the sharp turnaround in yields in Figure 6, which shows the change in interest rates across tenors in 2016 both before and after the election. The Fed is likely to hit at least two of its projected three hikes in 2017, and that may mean treading water for investors carrying interest-rate risk (duration), especially if the yield curve steepens (long rates rise more than short rates).

Figure 6: Shifting Yield Curve



Source: Bloomberg, December 2016.

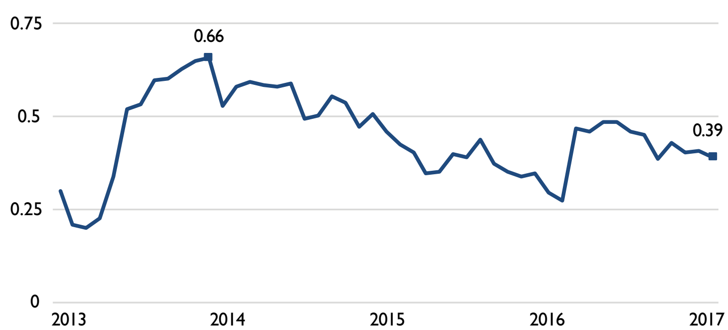
The credit cycle is showing signs of aging with credit spreads below their five-year average and upticks in lending standards by banks on consumer loans and credit cards. However, the credit markets are likely to benefit from policy measures that would stimulate economic growth, extending the cycle and consequent pick-up in defaults.

For example, the proposed removal of interest deductibility on debt issued by companies could reduce leverage employed by firms and thus increase their creditworthiness, providing a boost to existing holders of credit. Bank loans also look more favorable than high-yield bonds as a way to gain credit exposure for two reasons. First, they benefit from rising interest rates because their coupons are adjusted for changes in rates, removing interest-rate risk. And second, they are senior in the capital structure to high-yield bonds and are likely to perform better if defaults should rise unexpectedly. Finally, Treasury Inflation-Protected Securities (TIPS) are stuck between rising inflation (benefit) and rising interest rates (detractor), which have counter-balancing effects for the asset class.

Alternatives

Our view in 2017 is that alternatives will be favored over fixed income because the expected returns for bonds are muted, given already-tight credit spreads and the expectation for multiple interest-rate hikes. When properly diversified, alternatives can provide a low-volatility component to the portfolio that is not dependent on interest rates or credit quality. Additionally, as we can see in Figure 7, cross-asset correlations have been falling, which means that asset classes are behaving more independently. Higher correlation among asset classes limits the number of opportunities for alternatives managers because, broadly speaking, positions in different asset classes would tend to move similarly. By contrast, lower correlations allow skilled alternatives managers to identify value across a more diverse opportunity set, increasing the potential for returns and consequent diversification value.

Figure 7: One-Year Rolling Cross-Asset Correlation



Source: PLFA, Bloomberg, January 2017.

Note: Cross-asset index is comprised of Russell 3000 Index, MSCI ACWI ex-U.S. Index, Bloomberg Barclays U.S. Aggregate Bond Index, Bloomberg Barclays 2% U.S. High Yield Index.

Painting a Picture

Stimulus is likely to extend the late-cycle market in the U.S., and tax cuts and deregulation tend to favor value over growth and smaller over larger stocks, with mid-cap being the "sweet spot" between the two. Developed international stocks could benefit from a continued economic recovery, but face a serious challenge from the rise of nationalist movements. Emerging markets should benefit from expanding global growth and stabilizing commodities. Bonds are likely to see challenges with rising rates and already-tight credit spreads. And alternatives look favorable to bonds, especially as cross-asset correlations come down. With markets moving in so many conflicting directions, 2017 should demonstrate the value of thoughtful diversification.

Definitions

Protectionism refers to the theory or practice of restraining trade between countries through methods including tariffs on imported goods, quotas, and a variety of other governmental regulations.

A credit cycle is characterized by the expansion and contraction of access to credit by borrowers over time.

The New Silk Road refers to China's efforts to re-create the ancient Silk Road trade route that connected China with Central Asia, the Middle East, and Europe.

Duration is a measure of the sensitivity of the price of a fixed-income security to a change in interest rates.

Cross-asset correlations measure the degree to which the prices of assets move together.

The **S&P 500® Financials Index** measures the performance of financial components of the S&P 500® Index, which is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the U.S. stock market.

The **S&P GSCI® Index Spot** measures general price movements and inflation in the world economy, and provides a benchmark for investment performance in the commodity markets.

The **MSCI Emerging Markets Index** tracks the performance of equity stocks in selected emerging foreign markets.

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 December 31, 2016, PLFA manages approximately $37 billion in total assets.

Mailing address:
P.O. Box 9768, Providence, RI 02940-9768
(800) 722-2333, Option 2 • www.PacificFunds.com