



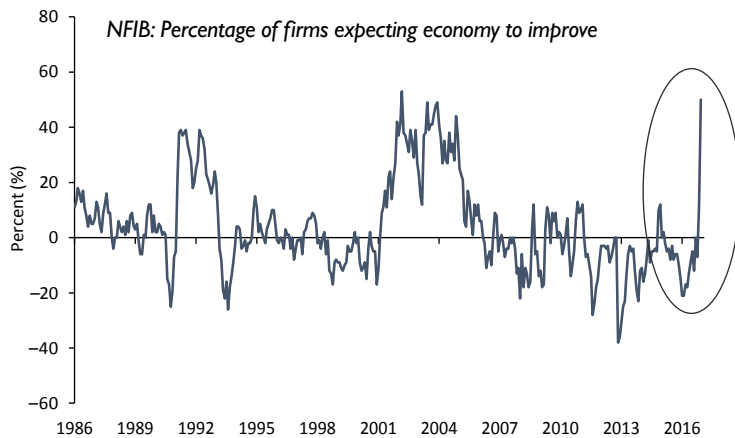
Informational commentary from Pacific Asset Management, the manager of Pacific Funds<sup>SM</sup> Fixed-Income Funds.

# Climbing the Wall of Optimism

Many of us have heard the expression that markets climb a “wall of worry.” With the recent surge in consumer and business confidence, will markets be able to climb a “wall of optimism”? That will most likely depend on sustained positive sentiment translating into higher spending, investment, and ultimately, economic growth. The key to sustaining sentiment currently rests in the hands of the new U.S. president’s administration. In this brief note, we discuss this notion and our overall positioning entering 2017.

Following the election of our 45th president, consumer and business confidence have soared. These near-record levels of optimism are being supported by the hope that fiscal policy, tax reform, and a decreased regulatory environment will stimulate growth. Households and businesses have shown this hope in their bullish outlook on forward-looking growth measures. Consumer-confidence measures have seen sharp improvements as the University of Michigan Consumer Sentiment Index reached a 14-year high in January. Additionally, the National Federation of Independent Business (NFIB) Index of Small Business Optimism saw its largest two-month move since 1986 (Chart I).

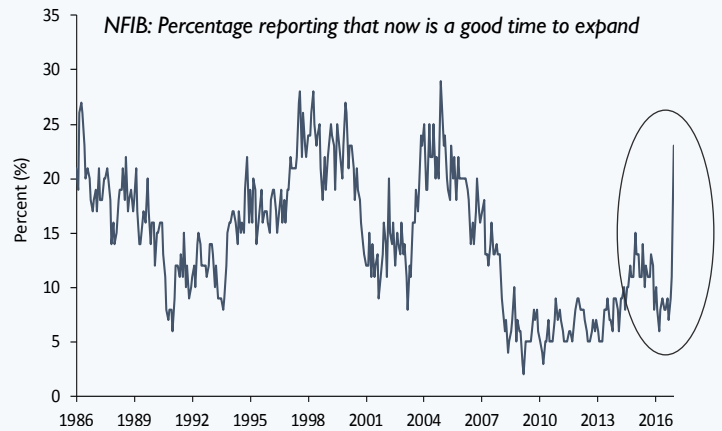
**Chart I: Business sentiment has surged postelection**



Source: NFIB, January 2017.

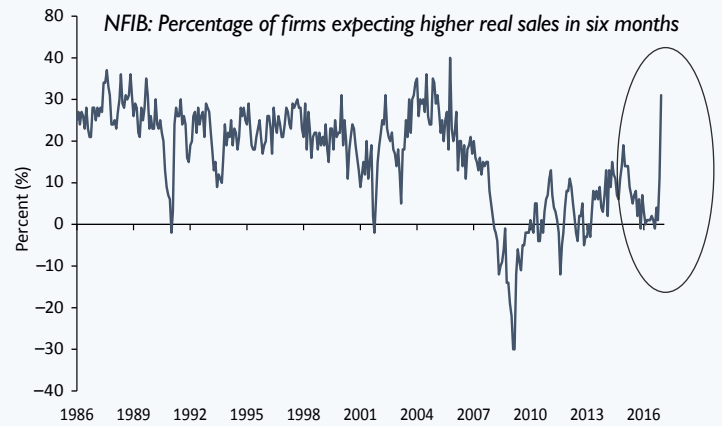
## Small-Business Sentiment Spike

**Small-business optimism has surged following the U.S. presidential election**



Source: NFIB, January 2017.

## The Trump effect: bullish growth sentiment



Source: NFIB, January 2017.

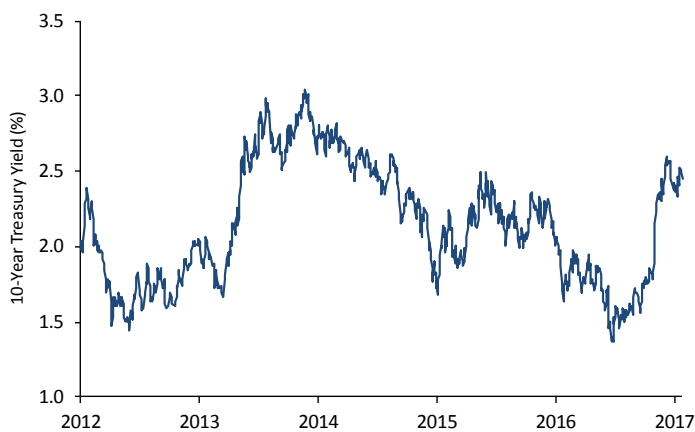


## The Reflation Trade

Prior to the presidential election, the U.S. economy had been gaining some momentum, with corporate earnings rebounding from 2015, unemployment continuing to move lower, and measures of inflation increasing. Despite this, most investors and economists had expectations of a U.S. economy growing around 2%, a pace consistent with the growth averages since the financial crisis.

Matters outside the U.S. were not as clear, as concerns around divergent central-bank policies, growth of developed world demand, and a slowing Chinese economy helped drive the 10-year U.S. Treasury yield to a record low 1.37% on July 8, 2016. While the yield moved off of the July lows going into election night, following the election, the 10-year Treasury yield surged more than 80 basis points (one basis point is equal to 0.01%). Add the fact that the “10-year breakeven inflation rate”, according to the Federal Reserve Bank of St. Louis, was higher by approximately 40 basis points postelection, and one could derive the move can be attributed to higher expectations for both growth and inflation.

**Chart 2: Treasury yields have retraced much of the pessimism in 2015–2016 surrounding growth**



Source: Federal Reserve Bank of St. Louis, January 2017.

Consistent with this dynamic, the S&P 500® index has rallied 6% since the election, reaching an all-time high of over 2,300. The CBOE Volatility Index® (VIX®) has plunged from a preelection spike of over 21, to under 12. And within high yield, spreads compressed back to 2014 levels (Chart 3). High-yield bonds have now produced positive monthly returns in 11 of the past 12 months. The internal dynamics

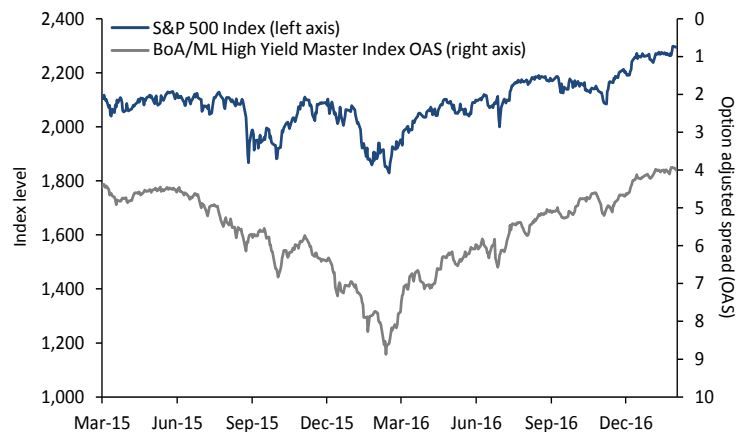
of high yield show the significance of the risk-on market environment. Bonds rated<sup>1</sup> CCC have returned 7.05% since November 8, 2016 and are up 40% during the past 12 months. Within high yield, the Energy and Metals and Mining sectors are up 54% and 53% during the past 12 months, respectively.

**Table 1: Risk asset outperformance continues**

| Index          | Return since Nov 8, 2016 | 1-Year Return |
|----------------|--------------------------|---------------|
| S&P 500® Index | 5.79%                    | 20.03%        |
| High Yield     | 3.23%                    | 17.13%        |
| Bank Loan      | 2.22%                    | 11.27%        |
| Corporate      | -1.51%                   | 6.06%         |
| Aggregate      | -1.91%                   | 1.45%         |

Source: Barclays, January 2017.

**Chart 3: Equity prices and high-yield spreads have moved with high correlation over the past year**



Source: Federal Reserve Bank of St. Louis, January 2017.

Markets are said to swing between greed and fear. The same can be said of sentiment swinging between optimism and pessimism. Given the moves in bond yields, inflation expectations, and risk assets since election night, it would be an easy conclusion to assume that the markets are optimistic about U.S. economic growth and inflation. However, the time to move from theoretical to practical is shortening. Despite the day-to-day headlines, capital markets seem very entrenched in the high-level expectations for fiscal stimulus,

<sup>1</sup>Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).



tax cuts, and regulatory reform. How these policies are implemented and the types of reforms in the first 100 days of the new presidency will be critical. At this point, markets may be susceptible to volatility, given how extended recent sentiment has become, especially if policy implementation falls short of expectations, or the darker side of protectionism takes precedence.

## Our Positioning into 2017

Short-term, capital market performance may continue to be driven by optimistic sentiment as positive business confidence can become self-fulfilling, pulling forward hiring and investment. We are already seeing signs of this as manufacturing data, new-order components, and hiring surveys have been strong during the past few months. Whether or not sentiment translates into sustained higher growth will show itself over the medium-term. That sentiment may very well be driven by the policy actions of the new administration.

So far in 2017, we see a continuing favorable credit market environment given the broad picture of corporate health.

We are cognizant, though, of market valuations that have moved significantly higher during the fourth quarter and throughout 2016. Thus, we are generally neutral yield and spread when compared to our benchmark and sellers of those areas of the market that, in our opinion, have moved too far in the short term.

The Pacific Funds Fixed-Income Funds focus on several themes. Generally, the funds maintain duration neutral to the benchmark, viewing U.S. Treasury yields in a fair-value range, given the reset in rates that took place in November. The funds are overweight companies with U.S.-centric businesses and revenues, given the favorable growth environment and possible protectionist trade policies. Further, they favor U.S. financials, in particular banks, and continue to favor little to no exposure to their foreign counterparts. Within credit asset classes, the funds favor bank loans over high-yield bonds from a relative-value perspective, given lower volatility and reduced yield concession, and we believe security selection is the best opportunity to drive outperformance this year.

## Definitions

The breakeven inflation rate is the point at which the yield of the nominal fixed-rate bond is equal to the yield of an inflation-linked bond of the same maturity. At this rate, both securities are equally attractive.

A bull market is characterized by investor confidence and rising prices. A bear market is characterized by investor pessimism and falling prices.

**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.

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

The **BofA Merrill Lynch U.S. High Yield Master Index** tracks the performance of U.S. dollar denominated below-investment-grade rated corporate debt publically issued in the U.S. domestic market.

The **CBOE Volatility Index® (VIX®)** is a key measure of market expectations of near-term volatility conveyed by S&P 500® Index stock option prices.

**Bank Loan** is 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 **National Federation of Independent Business (NFIB) Index of Small Business Optimism** is a composite of 10 Small Business Economic Trends (SBET) indicators that provides a monthly summary data point for the state of the small-business economy.

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.

The **University of Michigan Consumer Sentiment Index** uses telephone surveys to measure the overall health of the economy as determined by consumer opinion.

Spread is the difference between the quoted rates of return of two different investments.

Yield is the income return on an investment, including interest or dividends.

## 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 December 31, 2016, Pacific Asset Management managed approximately \$5.8 billion. Assets managed by Pacific Asset Management include assets managed at Pacific Life by the investment professionals of Pacific Asset Management.

This publication is provided by Pacific Funds. This commentary reflects the views of the portfolio managers as of March 3, 2017, are based on current market conditions, and are subject to change without notice. These views represent the opinions of the portfolio managers at Pacific Asset Management and are presented for informational purposes only. These views should not be construed as investment advice, an endorsement of any security, mutual fund, sector, or index, the offer or sale of any investment, or to predict performance of any investment. Any forward looking statements are not guaranteed. All material is compiled from sources believed to be reliable, but accuracy cannot be guaranteed.

All investing involves risk, including the possible loss of the principal amount invested. Debt securities with longer durations or fixed interest rates tend to be more sensitive to changes in interest rates, making them generally more volatile than debt securities with shorter durations or floating or adjustable interest rates. The Funds are also subject to other risks including, but not limited to, liquidity risk, risk of default, foreign markets risk, and credit risk. Please see the Funds' prospectus and/or summary prospectus for details on these and other risks associated with Pacific Funds Fixed-Income Funds.

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

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