January 2016

PACIFIC FUNDS

Manager Insight Series

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

The Wild West of 2016

Proceeding into the year 2016, especially in the shadow of 2015, it's looking remarkably similar to the wild west of days long past. To some, it represents opportunity, and to others it more resembles coming peril. 2015 cut an imposing impression. We all awaited the Federal Reserve's new sheriff, Janet Yellen, to pull the trigger on raising rates. The standoff between the world's oil producers, with none willing to cut production, caused the bottom to drop out of the global oil market. Global equities were challenged with a stampede of volatility not seen since 2011, and fixed-income markets tasted the first pain of tightening. With that backdrop, we will survey the investment themes that demand our focus through 2016.

Asset Class Outlook: Stocks, Bonds, and Alternatives

Stocks over Bonds

Even after a challenging 2015 for equities, we continue to favor stocks over bonds. The gradual raising of interest rates in the U.S. makes fixed income look less attractive, with the possible exception of credit, as we explore later. However, noting the slower grind of global growth, we expect double-digit returns to be hard to come by in developed equity markets.

One market force slated to return in 2016: volatility. The challenges to each asset class should provide fertile ground for active management to add value. From ever-present geopolitical dangers to the high impact of central bankers' increasingly divergent policies, opportunities abound on the flip side of every risk.

An Alternative to Middling Returns

Alternatives perhaps most closely resemble the landscape of the wild west – a landscape only vaguely defined and with new potential pitfalls. However, a select group of absolute-return strategies intended to be all-weather with performance that isn't hitched to the wagon of any one underlying asset class could shine through this cloudy climate of uneven growth and heightened volatility. Specifically, we favor liquid alternatives with global breadth, for example, Long/Short World Equity. Trading agility is a must when facing higher volatility. This leaves out more exotic alternatives like Master Limited Partnerships and Private Equity that are typically illiquid. We also view the event-driven space as unfavorable, given that mergers and acquisitions (M&A) activity is showing signs of a late-cycle peak (shown later in figure 3) and

Key Takeaways

- We prefer equities to fixed income due to Federal Reserve (Fed) tightening and continued, albeit slow, gross domestic product (GDP) growth.
- Liquid all-weather alternative strategies can benefit from the increased global growth dispersion.
- Value stocks may snap their long-term losing streak to growth stocks.
- International stocks stand to benefit from central bank support.
- Emerging markets are rife with risks but also opportunities.
- Credit is a potential opportunity in fixed income.

> "Tomorrow hopes we have learned something from yesterday."
>
> – John Wayne

distressed-investing strategies might be picking through minefields with an anticipated uptick in defaults, especially in the U.S. Energy sector. Quality active management and the ability to benefit from heightened pricing dislocation make select alternatives an attractive complement through 2016.

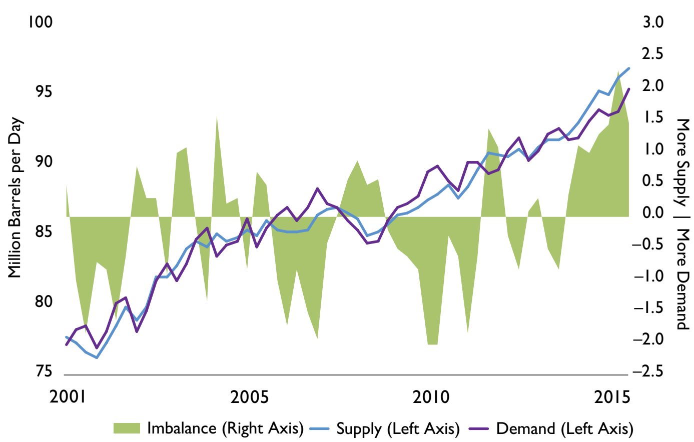
Domestic Equities

Value-Growth Divide

While growth may have overshadowed value in 2015, we expect that the primary catalysts for the 9.5% spread in returns are not sustainable. Tumbling global oil prices for value stocks and break-neck share buybacks for growth stocks may provide a lens to understand this divide along with clues as to its sustainability. The potential positive impact of rising rates on financials gives further grounds for our view that value stocks will outperform growth stocks in 2016.

Oil

Figure 1. Oil: Supply & Demand Imbalances



Source: International Energy Agency, Bloomberg, as of 9/30/15.

Energy was by far the worst-performing sector of the S&P® 500 index (–21.12%) in 2015 driven by plummeting crude oil prices in the face of persistent oversupply amid stagnant demand as shown in figure 1. Unfortunately, energy firms are nearly all categorized as value stocks (and would be an even "deeper" value now). The dynamic in the global oil market has shifted considerably with the advent of fracking technologies and development of shale-oil resources within the U.S., where production has nearly doubled in the last five years due to low extraction costs. A 14-day turnaround from investment to production and easy access to capital has made the U.S. shale industry a formidable competitor to established producers like Saudi Arabia and other major oil exporters. Nevertheless, if oil remains below $35, then not even the most efficient shale-oil producers can break even.

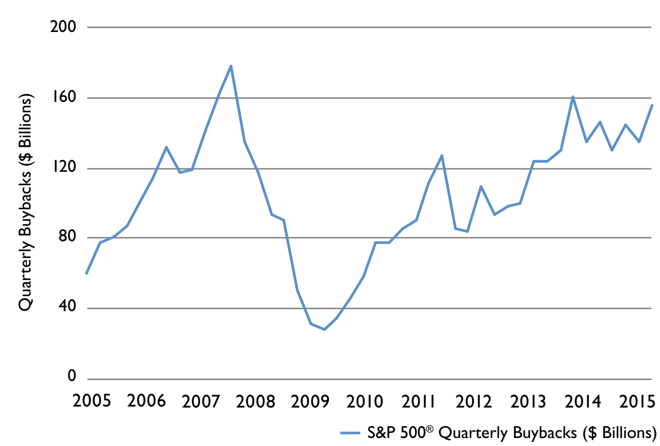
Saudi Arabia can produce oil for just $10–20 a barrel, but its substantial social welfare programs cannot all be sustained for more than five years with crude below $50. The gulf nation is thus torn between contributing to the supply glut so as not to give up market share to other oil producers and risking social unrest resulting from drastic spending cuts and other austerity measures.

Iran's supply coming online may contribute to the glut, but its officials have said that they do not intend to ramp up output too quickly and further suppress prices. Moreover, continued escalation of instability in the Middle East could wind up taking some of the supply offline. All this likely points to a modest rebound in prices in 2016, which would in turn provide relief for shares of domestic energy companies.

Share Buybacks

Historically, low oil prices naturally translate into cheap gas, and that gives more spending power to the consumer. The Information Technology and Consumer Discretionary industries (both considered growth sectors) benefited from this last year. Another key driver of their outperformance was share buybacks. Low rates meant the cost of debt was cheap, so companies issued bonds to buy back shares as seen in figure 2. Rising rates should begin to prove a headwind to buyback activity by driving up the cost of debt.

Figure 2. Share Buybacks



Source: Factset, as of 10/31/15.

Rising Rates

The impact of rising rates won't just stem share repurchases, but could also fundamentally improve earnings for financial companies. This factor figures into our longer-term preference for value stocks. Financials are the largest sector of the Russell 1000 Value Index and benefit the most directly from rising rates by charging higher interest, leading to improved net margins. Insurance companies also profit from the difference between liabilities and investment income, a difference which will grow as rates increase further over the coming years.

International versus Domestic

Divergence

Divergence of monetary policies may emerge as a key theme for 2016. Central bankers have typically preferred to move in unison to prevent drastic swings in currency as investors search for more attractive yields. The anticipation of increasing divergence, and escalating easing from the Bank of Japan (BoJ) and the European Central Bank (ECB), has already driven the dollar 28% higher against major international currencies since the start of 2013.

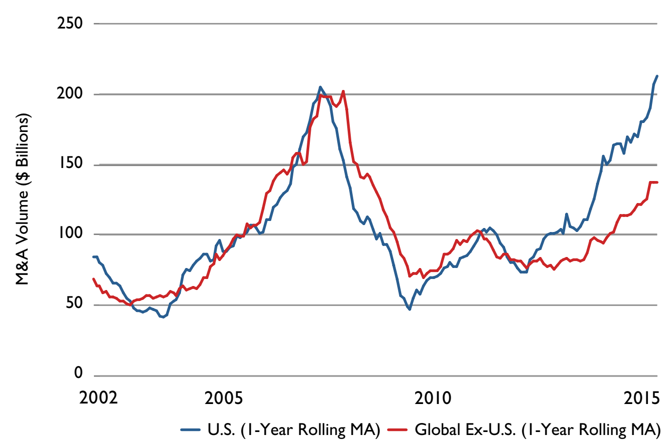
Many international developed markets, especially the EU and Japan, are showing accelerating if unsteady growth as they emerge from recession with full support of their central banks. The U.S., by contrast, with an economy that has long since recovered and entered a stable expansion, has stopped printing money and moved ahead on a quarter-point interest-rate increase in December. The result is an overseas market much more favorably positioned for growth with a cheaper currency boosting exports set against a domestic market where growth could be more challenging to find after a five-year bull market. Thus, we favor international equities over domestic with two caveats: One, diverging central banks can create wild currency fluctuations, which could serve to increase overall volatility. Two, investors in fragile overseas recoveries would benefit from a skilled bottom-up manager to sort out the bargains from the justifiably cheap as we outlined in our Manager Insights Series in September 2015.

M&A and Margins

M&A activity has also been a point of difference between U.S. and international markets, and peaking M&A activity has typically signaled that the current cycle may be long in the tooth. The U.S. M&A market has been red-hot, with big-name mergers like Dupont-Dow Chem, Pfizer-Allergan, American Airlines-U.S. Airways, and EMC-Dell. The M&A boom in the U.S. has been fueled by access to cheap funding, which may be challenged as rates rise and the cost of capital increases. More importantly, the increase in M&A activity beyond pre-crisis peak levels may be a sign that U.S. equities have entered late-cycle with less room to expand.

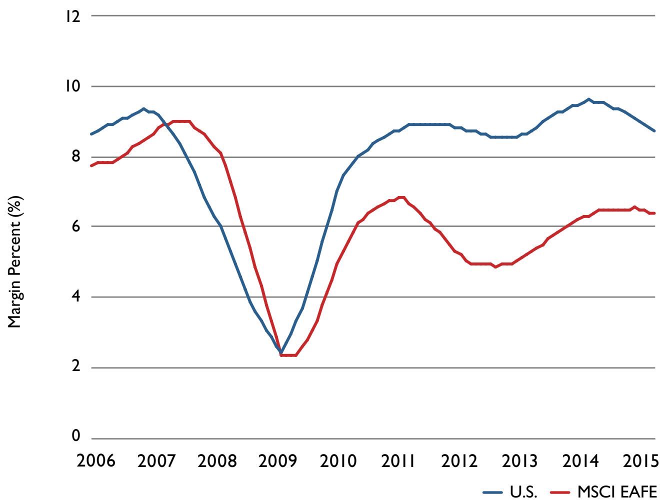
By comparison, shown in figure 3, global M&A activity has shown positive momentum at levels far below the previous peak, suggesting much greater opportunity for global equities. Another stark contrast is the momentum of profit margins of the U.S. and other major developed markets shown in figure 4. While U.S margins began contracting in January 2015, overseas nations have shown resilience, pointing to stronger potential for global earnings to keep improving.

Figure 3. U.S. versus Global ex-U.S. M&A Activity



Source: Bloomberg, as of 12/31/15.

Figure 4. U.S. vs EAFE Profit Margins



Source: Bloomberg, 12/31/15.

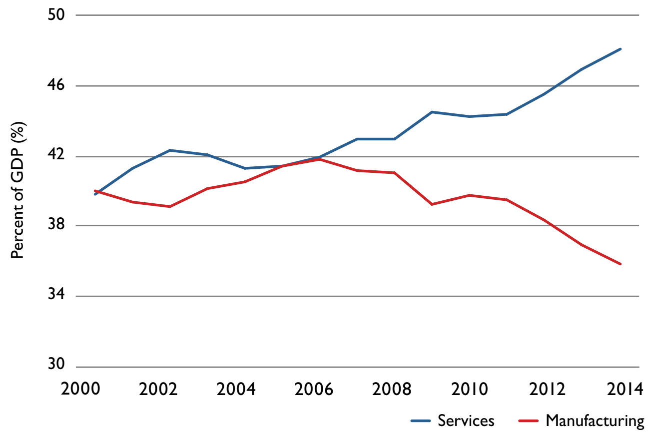
Emerging Markets

Developing economies faced a challenging 2015 in the face of below-forecast global growth, sharply lower commodity prices, and a lofty dollar. The MSCI Emerging Markets Index was off nearly 15% as concern mounted over how emerging economies will handle key structural changes amid these headwinds.

The need for infrastructure spending in developing economies remains high, with the World Bank estimating the need between $1.7 and $2.5 trillion in South Asia alone. However, major emerging economies like China are slowly transitioning away from an export, manufacturing, and infrastructure-heavy model of economic growth toward a services and internal-consumption driven model as seen in figure 5. The drop in manufacturing in China has a meaningful impact on commodity prices, as China makes up nearly 50% of the global demand for most industrial commodities.

A ripple effect of this transition in China is visible in economies tied to commodity exports, such as Brazil. The Latin American country is in a deep recession amid a toxic combination of contracting growth, policy tightening in the face of inflation, widespread corruption including a drawn-out impeachment, structural bottlenecks, and a drought.

Figure 5: China's Gross Domestic Product (GDP) Composition

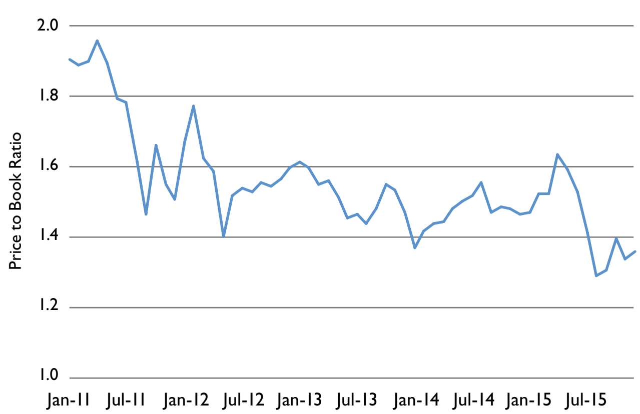


Source: The World Bank, data as of 12/31/14, released 12/31/15.

Despite having country-specific concerns, we have begun to evolve our outlook on emerging markets. We entered 2015 with a broadly bearish view, but have shifted to cautiously bullish, with an emphasis on caution, and a longer-term perspective. Concerns about China may be overdone or based on faulty assumptions, and current depressed valuations in emerging markets imply meaningful upside given a possible uptick in global growth for 2016.

When viewed through the lens of historic price-to-book ratios, emerging market equities are approaching levels last seen in the global financial crisis of 2008 shown in figure 6. Also, the bulk of capital flows out of emerging markets have typically occurred in the quarter prior to previous Fed rate hikes, indicating that the worst may already be behind us. Finally, aforementioned break-even pressures for higher oil prices should provide relief for oil exporters.

Figure 6. Emerging Market Companies: Price-to-book



Source: Bloomberg, as of 12/31/15.

A Focus on China

China has come to inhabit a unique place in the eyes of investors, having grown to the world's second largest economy perhaps in spite of a long history of top-down control and meddling over-reaction to perceived economic risks. The course set in the Communist Party of China's most recent thirteenth iteration of the five-year plan show a desire for continued transition to consumption-driven economic growth and financial liberalization. As shown previously in figure 5, China's attempts to transition its economy can be viewed as largely succeeding with all local markets strongly positive in 2015, especially the Shenzhen Stock Exchange, which was up over 63%.

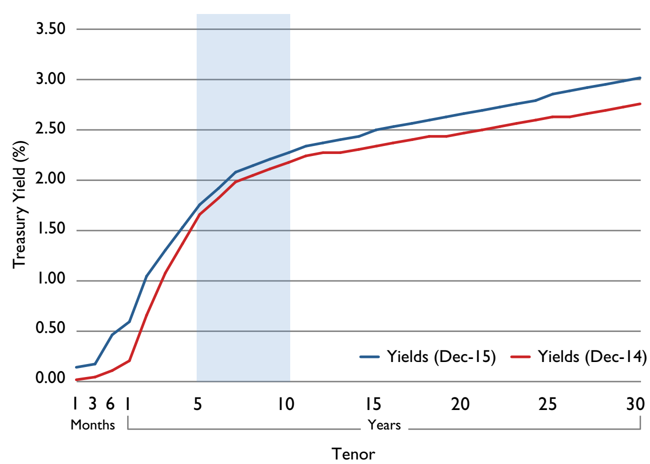
However, many investors outside the country are overly focused on the contraction in Chinese manufacturing and have not bought into Beijing's five-year plan, leading to increased volatility. Chinese regulators have also struggled to manage stock exchanges that mix inexperienced retail investors, new-found financial leverage, and growing access for foreign investors. Policies such as selling bans for large stockholders and excessively restrictive halts to trading are further exacerbating volatility by contorting the invisible hand, the theory that markets are efficient without government intervention. Our long-term view is bullish on the Chinese economic and market transition, but we emphasize the need for diligence and active management in sorting through the noise to find sound investment in China and emerging markets more generally.

Fixed Income

Belly of the Curve

Fixed-income markets struggled as anticipated in 2015, and 2016 looks to increase pressure on the asset class. The Fed's projection for further rate increases over the next year will suppress returns of shorter-term Treasuries and investment-grade corporate issues, while subdued inflation expectations and generally long duration may dampen the attractiveness of Treasury Inflation-Protected Securities (TIPS). Thus, we prefer to be in the belly, or the five-to-ten-year portion, of the yield curve. As shown in figure 7, rising yields have thus far chiefly impacted the wings, which are the short and long ends of the curve. Looking beyond core bonds, high-yield bonds and bank loans offer the most promise in 2016.

Figure 7. U.S. Treasury Yield Curve

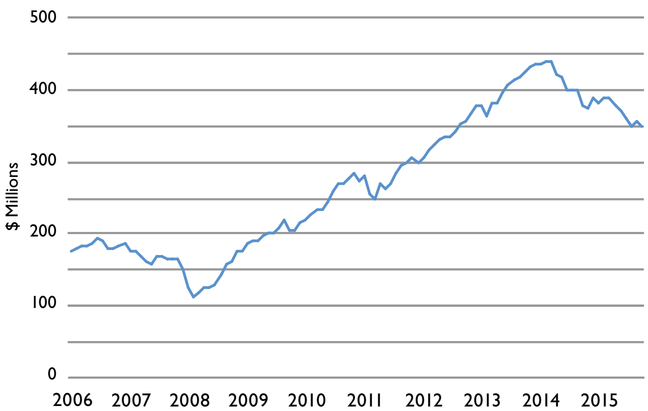


Source: Bloomberg, as of 12/31/15.

High Yield

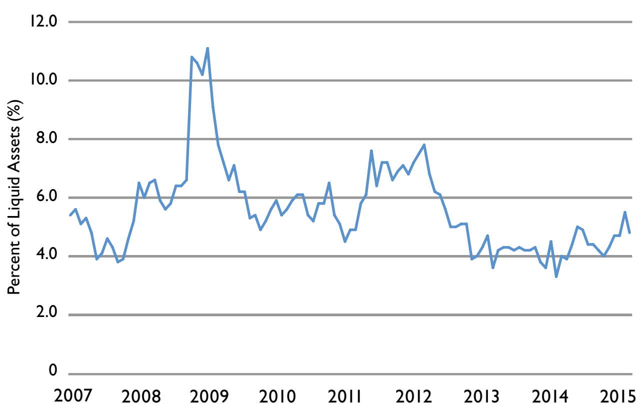
Even after a tough 2015 that saw widening spreads and rising defaults, high-yield may provide the best opportunity for returns within fixed income in spite of potential challenges. Leverage is high due to the preference for debt over equity financing in the current low-rate environment, a trend only intensified by the whirlwind of M&A and buyback activity previously discussed. Liquidity presented a challenge as investors ramped up redemptions (figure 8), squeezing managers of deeply distressed issues. We see these concerns meaningfully addressed, however, by healthy levels of interest coverage and increased cash holdings by managers in anticipation of further outflows (figure 9). Our primary concerns are more tail-risks and the possibility that the energy market slump continues unabated or significantly worsens.

Figure 8. High-Yield Mutual Fund Assets



Source: Bloomberg, as of 11/30/15.

Figure 9. Share of Liquid Assets within High-Yield Mutual Funds



Source: Bloomberg, as of 11/30/15.

Bank Loans

Another segment of the credit market we like is bank loans. With a historical tendency to outperform core bonds by 4.5% during periods of tightening and seniority in the capital structure, loans provide an attractive and diversifying exposure to fixed income. Liquidity is our principal concern, and once again, we emphasize the value of management, with a buy-and-hold approach much preferable in a market prone to sudden droughts of liquidity. In all, credit provides a relatively attractive opportunity within a challenging fixed-income market for investors with strong stomachs.

Circle the Wagons

We believe diversification will be a cornerstone to a successful outcome in 2016. Investors with patience and a focus on their investment horizons may be able to weather volatility and be rewarded, even if not at the generous levels seen in 2013 and 2014. In the wild west that is 2016, keep your head up, your feet on the ground, and your eyes firmly placed on the horizon.

S&P 500 Index is a capitalization-weighted index of 500 U.S. stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Results include the reinvestment of all distributions.

Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics. Results include the reinvestment of all distributions.

MSCI Emerging Markets Index (Net) is a free float-adjusted market capitalization index that is designed to measure equity market performance of large and mid-capitalization securities in emerging markets. As of April 1, 2015, the MSCI Emerging Markets Index (Net) consists of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates. The word "(Net)" in the index name means the net total return for the index, which includes the reinvestment of dividends after the deduction of withholding tax, applying the tax rate to non-resident individuals who do not benefit from double taxation treaties.

About Pacific Life Fund Advisors

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

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