PACIFIC FUNDS Manager Insight Series

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

Fiscal Policy to the Forefront

As we enter the second half of 2017, the risk-friendly market environment, which began in the first quarter of 2016, has continued. Business sentiment has remained high, pushing many asset valuations to less-attractive levels. With both sentiment and valuations on the high side, U.S. real gross domestic product (GDP) continues struggling to consistently grow above 2%. With the Federal Reserve (Fed) raising the target rate three times in the past seven months, monetary policy is now less of a tailwind, with some arguing that it may soon become a headwind. This scenario puts more focus on fiscal and regulatory policy. In this note, we discuss the market environment, fiscal and regulatory policy, and our broad positioning.

Marching Higher

Risk assets have seen a nearly uninterrupted march higher since February 2016, with accelerated momentum since the November elections (see Table 1 and Chart 1). The so-called "reflation trade," which are those investments benefiting most from possible fiscal reform and growth sentiment, have seen the strongest total returns. The rally has also been notable for its lack of volatility. The CBOE Volatility Index® (VIX®) index has hovered near all-time lows for a sustained period (Chart 2). In the past five years, the VIX, has recorded readings below 10 on seven trading days, all occurring in May and June of this year. In many ways, all news has been good news. Positive data surprises have supported sentiment and negative data has implied a slower-to-tighten Fed and more accommodative monetary policy.

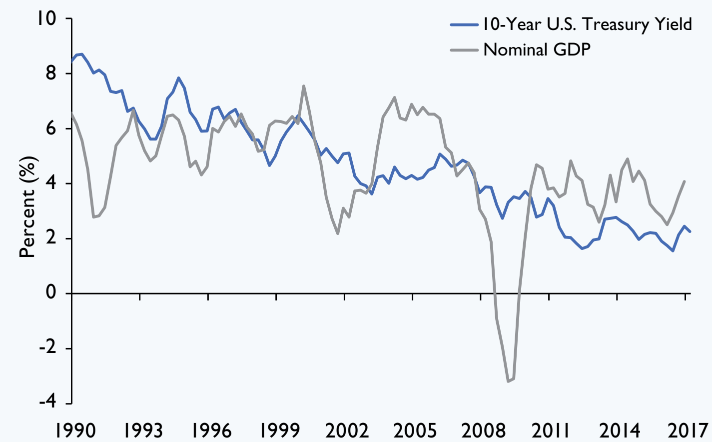
Table 1: Risk asset outperformance continues

Index	YTD Return	1-Year Total Return
S&P 500® Index	9.34	17.90
High Yield	4.93	12.70
Bank Loans	1.96	7.49
Corporate	3.80	2.28
Aggregate	2.27	-0.31
Treasury	1.87	-2.32

Source: Bloomberg Barclays, S&P®, and Credit Suisse, as of June 30, 2017.

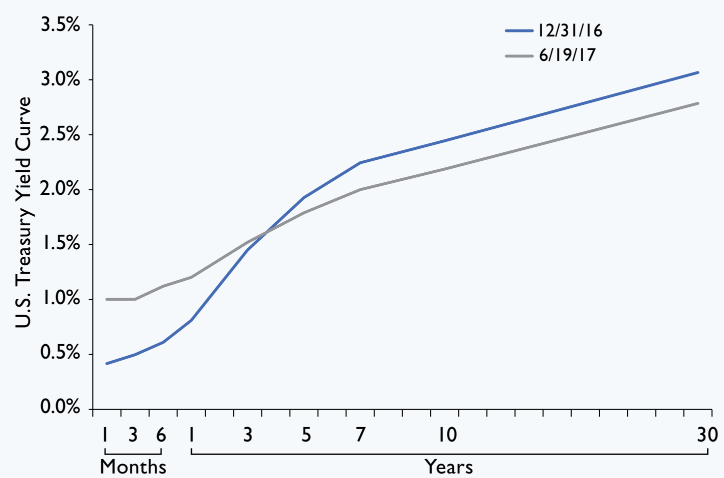
Bond Investors Are Less Optimistic

Higher growth will be needed to sustain higher U.S. Treasury yields



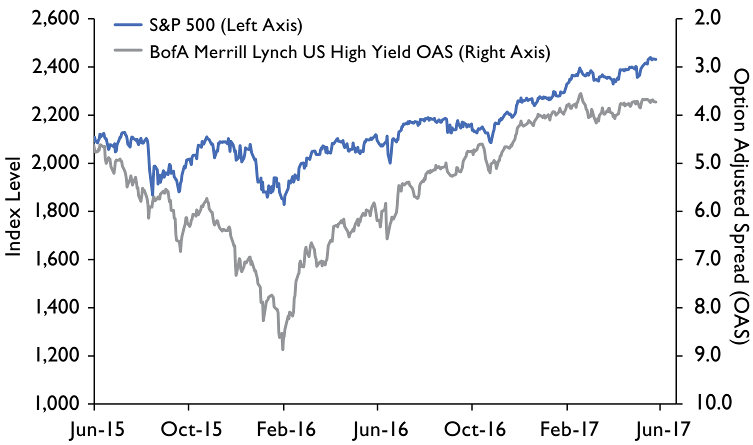
Source: Federal Reserve Bank of St. Louis, as of June 30, 2017.

With intermediate- and longer-term yields moving lower in 2017 thus far, bond investors are less optimistic



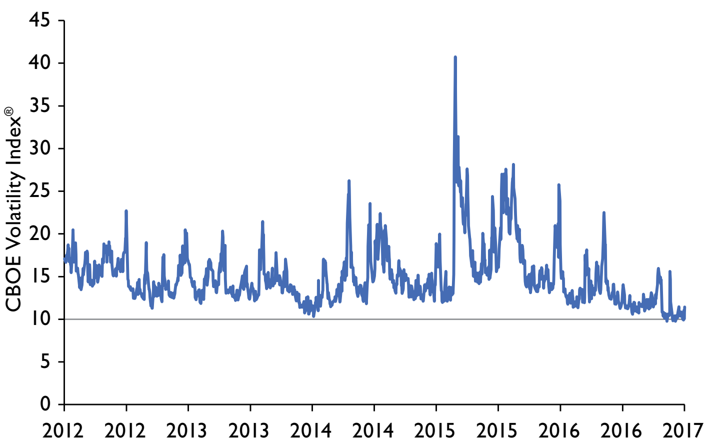
Source: Bloomberg Barclays, as of June 30, 2017.

Chart 1: A nearly uninterrupted move higher in risk assets



Source: S&P®, Merrill Lynch as of June 16, 2017.

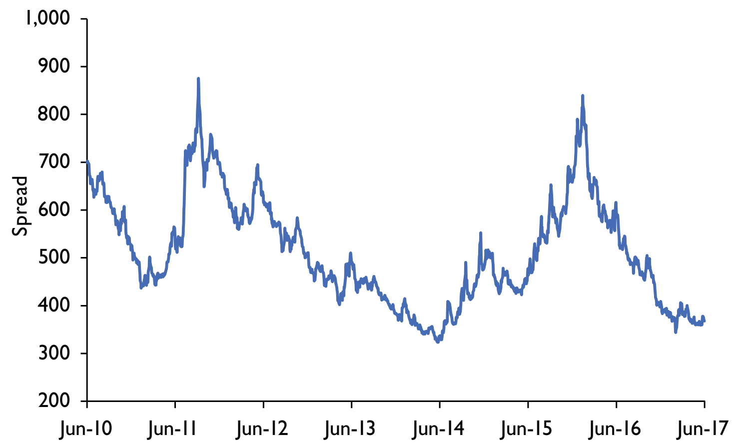
Chart 2: Volatility has been remarkably low during 2017



Source: Federal Reserve Bank of St. Louis, as of June 30, 2017.

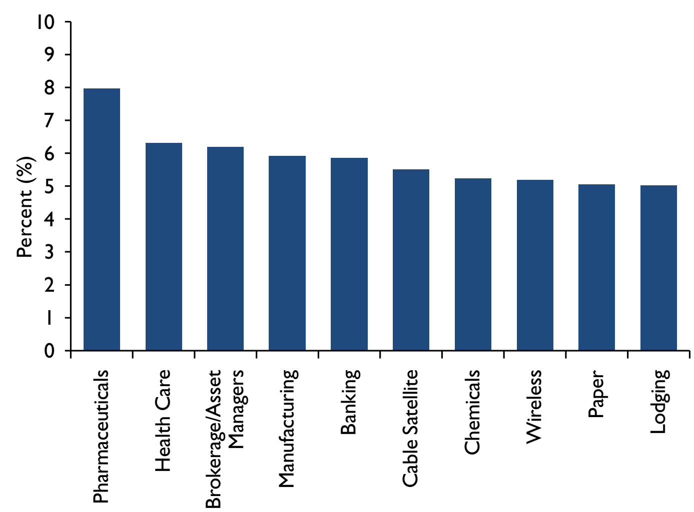
Credit markets have also benefited from market sentiment. High-yield spreads have moved to the lower part of the post-2010 range and the lowest levels seen since 2014 (Chart 3). Corporate bonds have also been buoyed by market sentiment, lower Treasury yields, and particularly strong technicals. Year-to-date investment-grade bonds have seen record inflows. Corporate bonds are on track for the third consecutive year of record-setting foreign demand driven by relative value, more stable fundamentals, higher yields, and less-systemic risks.

Chart 3: High-yield spreads have moved back to 2014 lows and are in the bottom part of the range of the past 20 years



Source: Bloomberg Barclays, as of June 30, 2017.

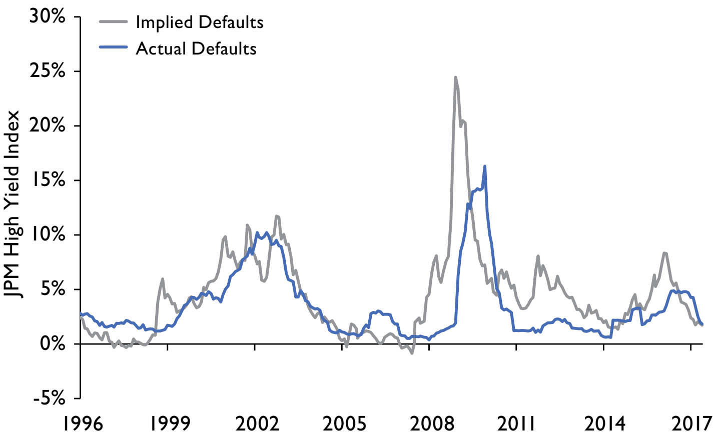
Chart 4: Performance has been strong for those sectors potentially impacted by fiscal stimulus or deregulation



Source: Bloomberg Barclays, as of June 30, 2017.

Strong corporate health has also contributed to lower credit spreads. Stabilized earnings, positive business and sentiment measures, retail sales, as well as manufacturing and activity surveys point to a favorable fundamental backdrop in the short term. Meanwhile, corporate pricing power is showing signs of improving, and earnings estimates for 2017 are robust. Companies have taken particular advantage of wide-open capital markets this year to refinance debt, removing any concerns of a maturity wall in the near term. Implied default rates (below 2%) are indicative of the favorable backdrop supporting credit-risk premiums (Chart 5).

Chart 5: Actual and implied default rates have converged to low levels given favorable corporate health

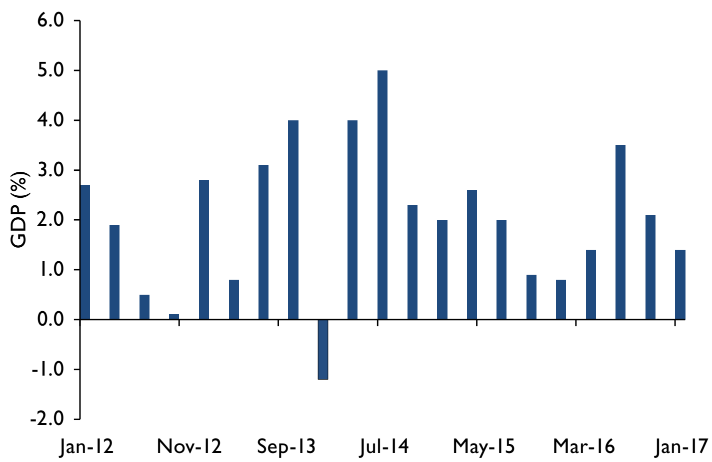


Source: J.P. Morgan, as of June 1, 2017.

But Where Is the Growth?

Despite the surge in sentiment measures and strong corporate health, the first estimate of first-quarter GDP came in at 0.7% (third estimate revised to 1.4%), which is below the 2% slow-growth range. This has led to concerns that despite the surge in "soft" data measures such as sentiment, economic growth remains stuck in a sub-3% environment, which has defined this business cycle. While first-quarter GDP readings are historically weak given weather and seasonal-related distortions, the GDP reading was one the lowest readings in the past three years (Chart 6).

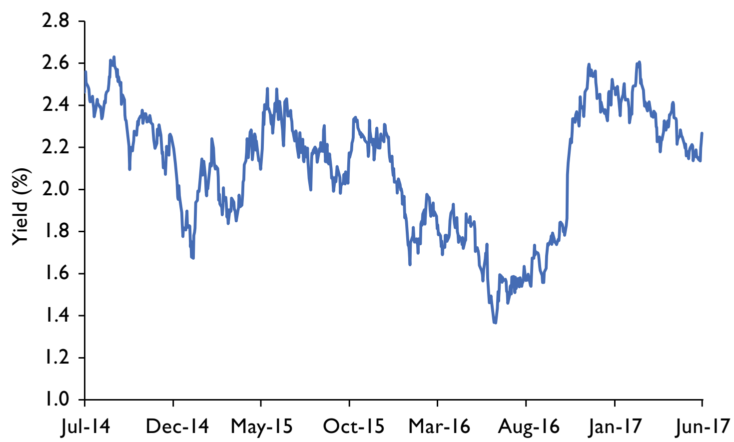
Chart 6: U.S. GDP remains stuck in the low-growth environment that has been a hallmark of this business cycle



Source: Federal Reserve Bank of St. Louis, as of March 31, 2017.

There are signs, however, of an improved outlook for the second quarter. Much of the "hard" data of consumption and investment may be catching up to the "soft" data of sentiment and surveys. Employment data, including aggregate hours worked, nonfarm payrolls, and the Job Openings and Labor Turnover Survey (JOLTS) results point to a strong labor market. Manufacturing surveys show a sharp increase in activity, and retail sales are moving higher with consumer confidence. The Federal Reserve Bank of Atlanta GDPNow™ forecasting model[1] currently estimates a 3% second-quarter 2017 GDP. This is a strong rebound from the first quarter, but annualized readings remain well within the 2% GDP range seen during the past few years.

Chart 7: The 10-year U.S. Treasury yield has retraced much of the November "reflation" move



Source: Bloomberg Barclays, as of June 30, 2017.

Fiscal and Regulatory Policy Remains the Key

With the Federal Reserve embarking on rate hikes for the first time since the financial crisis, the tailwind from monetary policy is being reduced. Thus, the key to higher U.S. growth lies with fiscal and regulatory policy. Since the November election, consumer and business outlooks have sharply improved on the hope that fiscal, tax, and regulatory policy would help catapult growth. Investors have held on to the prospects of three meaningful expectations from the new administration: lower corporate tax rates, increased infrastructure spending, and fewer regulations. With sentiment and expectations high, an inability to pass various policies would lead to a downward

[1]The Federal Reserve Bank of Atlanta GDPNow forecasting model provides a preliminary estimate of gross domestic product (GDP) prior to the release of the official estimate of GDP.

revision of growth expectations, sentiment, and—most likely—risk assets.

Our Positioning into the Second Half of 2017

As we enter the second half of 2017, we find opposing forces leading to generally risk-neutral positioning. A favorable fundamental backdrop, anchored by stable corporate health, coupled with a positive technical backdrop driven by investor demand for yield, gives an attractive bottom-up view of U.S. credit. Given the favorable outlook, we recognize the current rally may have further to go. However, too much optimism may be priced in given the ability of fiscal and regulatory policy to translate to higher economic growth rates than previously experienced during the past few years.

Current market sentiment also does not account for possible external shocks that could bring about a rekindling of volatility, thus expanding risk premiums. We believe a lack of fiscal stimulus, tax reform, or an unclear regulatory outlook coupled with hints of macroeconomic shocks could lead to an increase in volatility, providing opportunities to allocate more into risk assets later in the year. Therefore, we expect portfolio alpha to be focused on bottom-up security selection and individual company themes versus an explicit overweight or underweight to beta risk.

Pacific Asset Management

July 2017

Definitions

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.

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

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

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.

Hard data describes data that can be quantified or measured and is often backward-looking. Examples include retail sales, housing sales, and business spending.

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.

The **Job Openings and Labor Turnover Survey (JOLTS)** program produces data on job openings, hires, and separations.

Soft data describes data that is anecdotal and gathered through informal communications and is often forward-looking. Examples include poll-driven reports such as consumer-confidence and business surveys.

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 June 30, 2017, Pacific Asset Management managed approximately $7 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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