PACIFIC FUNDS

PERSPECTIVES

JANUARY 2018

Our investment managers discuss insights, themes, and trends that may shape the markets.

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Are low levels of volatility and continued growth sustainable? In times like these, it's important to work with investment managers who are experienced at navigating these market trends.

We believe active management around the tailwinds and headwinds that affect growth will have important investment implications for 2018.

tailwind

noun tail•wind \'teyl-wind
A condition or situation that will help move growth higher.

headwind

noun head•wind \'hed-wind
A condition or situation that will make growth more difficult.

FIXED INCOME

MANAGED BY PACIFIC ASSET MANAGEMENT

TAILWINDS

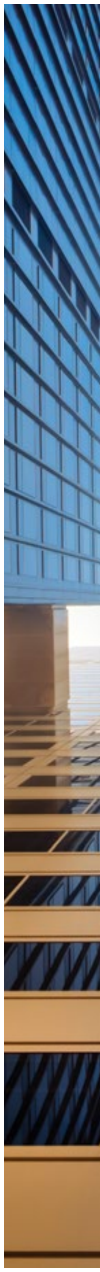
2017 was defined by favorable market conditions and economic optimism driving risk-asset outperformance. Improved corporate profits, increased global growth, and a remarkable absence of volatility all contributed to the "risk-on" market environment. Within credit, high-yield bonds benefited and produced above-coupon total returns. In addition, corporate bonds have been buoyed by market sentiment, lower Treasury yields, and a particularly strong technical backdrop for long-duration assets. Corporate-health measures have also provided a favorable bottom-up backdrop as earnings, business, and sentiment measures, as well as manufacturing activity are supporting current spreads.

HEADWINDS

Despite stabilized economic data and corporate profits, U.S. gross domestic product (GDP) continues to annualize below 3.0%, a level considered to be average or at the trend rate of growth. Whether or not growth sentiment will lead to acceleration in economic activity sustainable for above 3.0% growth rates remains uncertain. If growth rates were to remain consistent with the 2.0% level seen during this cycle, a repricing of valuations and credit-risk premiums may bring some volatility. Tax reform may be a potential catalyst for an acceleration in economic growth. Though, we remain skeptical that a business cycle eight years old can be accelerated through fiscal action. There may be too much optimism priced into risk assets on the hopes of economic growth from fiscal, tax, and regulatory reform.

POTENTIAL INVESTMENT IMPLICATIONS

At the close of 2017, we found ourselves moving to underweight risk positions relative to our benchmarks. From a bottom-up perspective, we have a favorable view of corporate health, potentially leading to a continuation of credit-risk outperformance into the new year. However, with valuations moving toward the high part of the range seen since 2010, we are broadly underweight risk and would welcome a return of volatility. Another concern is toward current market sentiment not accounting for possible external shocks that could bring a repricing of risk premiums. We believe a failure of fiscal stimulus or hints of macroeconomic shocks could lead to an increase in volatility, providing opportunities to allocate more into risk assets. 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.



U.S. EQUITY

SUBADVISED BY Rothschild Asset Management

TAILWINDS

Markets responded favorably to economic and political developments during December 2017. An earlier report of 3.0% growth in third-quarter gross domestic product (GDP) was revised upward to 3.3% by the Commerce Department. The Conference Board Consumer Confidence Index reached a 17-year high in November, reaching 129.5, up from 126.2 in October. Unemployment remains low at 4.1%, and even the more broadly defined U6 unemployment rate—which includes the underemployed and those who have given up looking for work—has declined to its lowest level since 2001. Despite the strong employment picture, inflation remains in check, with the Federal Reserve's preferred indicator, personal consumption expenditure (PCE), up just 0.1% in October, and only 1.6% for the trailing 12 months. Although the Institute for Supply Management's Purchasing Managers Index declined by 0.5%, to 58.2%, the reading remains north of the 50% threshold typically signifying expansion in manufacturing activity.

Following passage in the U.S. House of Representatives and the U.S. Senate, President Trump signed into law a series of much-anticipated tax reforms. Corporate taxes will be lowered from 35% to 21%; rates for individuals were also lowered, though the deduction for interest on mortgages was limited to a loan value of $750,000. The news was positively received by equity investors. Some observers are optimistic that the passage of tax reform also may be symbolic of the Trump administration's ability to partner effectively with Congress. If so, other pro-growth campaign policies—such as trade reform and infrastructure spending—could be back on the table.

HEADWINDS

Valuations have certainly given some investors pause, with the S&P 500® index and other indexes trading above long-term average multiples. But in addition to high consumer confidence and low unemployment, the bottom line continues to improve, with stocks in the S&P 500® stocks index expected to deliver earnings growth of 11.2% during the fourth quarter of 2017, according to FactSet.[1]

Similarly, it's possible that the proposed tax cut will cause inflation to creep up quickly, as companies deploy that excess cash into capital expenditures. There is also the risk that the tax bill won't pay for itself and lead to increased budget deficits, though such effects may not be immediate.

At its December meeting, the Federal Reserve (Fed) decided to raise the federal funds rate by 0.25% and suggested that it may raise rates an additional three times in 2018, and two more times in 2019 and 2020. Although markets were not caught off guard by this decision, a series of continued interest-rate hikes could diminish investors' willingness to tolerate high equity valuations.

POTENTIAL INVESTMENT IMPLICATIONS

Though the valuation of the broader market continues to rise, corporate earnings also continue to exhibit positive momentum—even before considering the potential tailwinds provided by tax cuts—which could further boost the bottom line. We will continue to take a bottom-up approach, seeking stocks with attractive valuations relative to peers and the potential to exceed expectations.

[1] Jones, Chuck. "S&P 500's September Quarter Earnings Growth Built On Energy." Forbes Investing/#MarketMoves. Forbes. September 30, 2017

MULTI-ASSET

MANAGED BY PLFA

TAILWINDS

Capital expenditures are likely to continue increasing for domestic firms through 2018, which should provide the greatest tailwind. These investments will likely require a higher degree of skilled labor, pushing up wages, productivity, and ultimately spending by the U.S. consumer, which accounts for more than two-thirds of gross domestic product (GDP). The recent tax package and the prospect for infrastructure spending should likewise push economic activity and corporate earnings higher, which aligns with expectations for higher growth across developed and developing economies worldwide. These tailwinds represent an oft-cited Goldilocks scenario where moderate growth prolongs the bull market while the three bears of market euphoria, inflation, and protectionism remain dormant risks.

HEADWINDS

Many prominent headwinds for investors have receded for 2018 and remain asleep now, though we would view them as significant risks if they were to wake. Much of the extreme U.S. election-year rhetoric in 2016 around protectionism in reference to the North American Free Trade Agreement (NAFTA) and the U.S. approach toward China have not materialized as policy in 2017. However, the negative impact on global growth should the U.S., the world's largest importer, or other major economies turn inward, is significant. While nationalist movements have not won elections in France or Germany, they have maintained a presence in regional parliaments and could pose a challenge to global trade should voter sentiment shift once again. Upcoming elections in Italy and Spain will once more test populism's appeal. Meanwhile, Brexit is only just beginning to weigh on the U.K. economy. Inflation is also expected to pick up globally in the latter part of 2018, which may bring about a swifter shift away from accommodative central-bank policies that have propped up asset prices worldwide.

POTENTIAL INVESTMENT IMPLICATIONS

The prevalence of tailwinds and retreating headwinds points to continued outperformance of risk assets, such as equities, domestically and abroad. The U.S. equity markets finally may favor value stocks because they generate more revenue domestically than growth stocks, and therefore stand to benefit more from tax reform as well as potential infrastructure and regulatory reforms taking place here in the U.S. A combination of central-bank tapering, gradually rising global inflation, and the coming uptick in the Federal Reserve's (Fed's) balance sheet unwind finally may send longer maturity yields higher and temper the curve flattening thus far caused by the Fed's rate increases. And while the major risks to markets are not active headwinds, investors would be wise to look out for any signs of market euphoria, inflation shocks, or protectionist policy that, while likely to remain asleep for 2018, could wake and spoil the party.

ALTERNATIVES

MANAGED BY PLFA

TAILWINDS

We weigh the outlook for alternatives by comparison to themes impacting traditional assets such as equities and bonds. Higher short- and long-term yields through 2018 are likely to weigh on fixed-income returns, particularly on government and high-quality debt with longer duration. Lower-volatility absolute-return alternatives stand to benefit by comparison, especially with an increasing dispersion across global interest rates providing larger currency carry trade opportunities for global macro managers. Higher global growth and more stable commodities also should benefit emerging-market equities. By comparison to the tight spreads and late-cycle concerns over U.S. credit, emerging-market (EM) debt should provide better carry, and potentially at higher quality. EM debt should furthermore receive additional support from a weaker U.S. dollar, which remains overvalued on several measures including purchasing-power parity. Gradually rising global inflation should support commodities and other real assets, especially if it surprises to the upside.

HEADWINDS

The biggest headwind for alternatives continues to be the low-volatility environment paired with recent equity returns that might make alternatives appear less attractive, if compared only to equities. Tax reform and potential infrastructure investment in the U.S. are likely to reinforce that comparison. Real estate also may see pressure as interest rates rise and investors looking for income gravitate back toward low-risk assets such as corporate debt.

POTENTIAL INVESTMENT IMPLICATIONS

Investors tend to adjust their expectations for higher returns after a strong market year as we experienced in 2017, but higher valuations and indicators suggesting we are in the later stages of an economic expansion argue that returns actually should be lower in the future. If investors find the prospects for equities in 2018 too good to turn down, they may find clearer advantages from alternatives within their fixed-income allocations. Broadly diversified alternatives should provide a helpful complement to the longer duration of core bonds and the tight spreads of credit while remaining unconnected to the typical trade-offs inherent in hedging those risks. And if Goldilocks is surprised by a bear, alternatives may even provide much-needed diversification to better weather an unexpected drawdown.

WHY PACIFIC FUNDS℠

Pacific Funds is a family of mutual funds designed for growth, income generation, and diversification. Our managers seek to deliver consistent results with downside protection strategies to help shareholders meet their long-term financial goals.

We are a multi-manager investment company consisting of managers who are:

Selective	Our managers implement strategies using highly selective, active, and process-oriented approaches that have stood the test of time.
Nimble	Each manager is efficiently structured to be nimble when implementing investment decisions, while being supported by the resources of a large financial institution.
Experienced	The managers have extensive institutional experience in their respective asset classes and in navigating varying financial environments.

For additional information on our managers' views, visit us at www.PacificFunds.com/Perspectives.

Statistical information presented in this publication is sourced from the following:

"Gross Domestic Product: Third Quarter 2017 (Second Estimate) Corporate Profits: Third Quarter 2017 (Preliminary Estimate)." News Releases Bureau of Economic Analysis. U.S. Department of Commerce, November 29, 2017.

"The Conference Board Consumer Confidence Index Increased Again." Consumer Confidence Survey®. The Conference Board, November 28, 2017.

"The Employment Situation - November 2017." News Release Bureau of Labor Statistics. U.S. Department of Labor, December 8, 2017.

"Trimmed Mean PCE Inflation Rate." Current Report. Federal Reserve Bank of Dallas, October 2017.

"November 2017 Manufacturing ISM®." ISM Report on Business. Institute for Supply Management, December 1, 2017.

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