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

BBB Bubble?

What Record Debt Means to Investment-Grade Bond Investors

Investors have become increasingly concerned about the sharp rise in BBB rated corporate debt, and it's easy to see why. BBB debt has risen over 200% since 2008 and represents about 50% of the investment-grade corporate market's debt.

Taking advantage of low-interest rates, BBB rated companies have racked up $2.5 trillion of debt in less than a decade. Slow economic expansion since the financial crisis, coupled with increased uncertainty in global growth over the past few years, has resulted in companies favoring mergers, acquisitions, dividends, share repurchases, and cost-cutting strategies rather than capital expenditures.

With these debt increases, many investment-grade rated companies have downgraded their balance sheets to levels consistent with mid-to-low BBB ratings and, in some instances, to leverage levels consistent with below investment-grade ratings. Thus far, many companies have been able to retain investment-grade ratings by promising to reduce leverage in upcoming years. For now, rating agencies are giving management teams the benefit of the doubt, allowing them to maintain their investment grade rating as they work to reduce leverage.

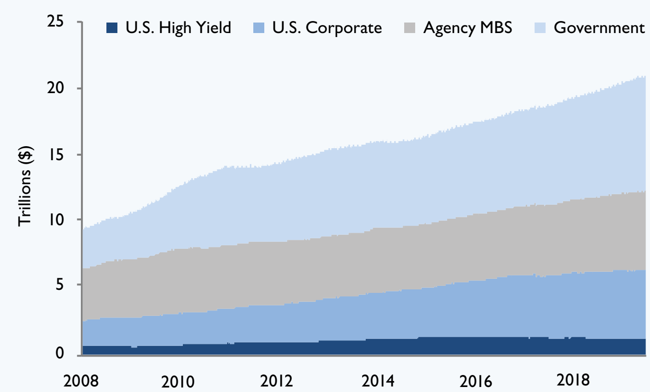
With record BBB rated debt generating frequent headlines, we sat down with **David Weismiller** and **Ying Qiu**, portfolio managers for Pacific Asset Management's investment-grade bond strategies, to get their insights into what's happening in the BBB space and how this record debt could affect investors.

How valid are the commonly held concerns regarding leverage levels in the BBB space?

Some concern is warranted. Leverage across the corporate landscape sits at historically high levels (Chart 1). This coincides with predictions by many economists that economic growth will be muted going forward. These two dynamics are typically not a great combination for credit investors or risk assets. Furthermore, interest-coverage levels have become worrisome in certain sectors.

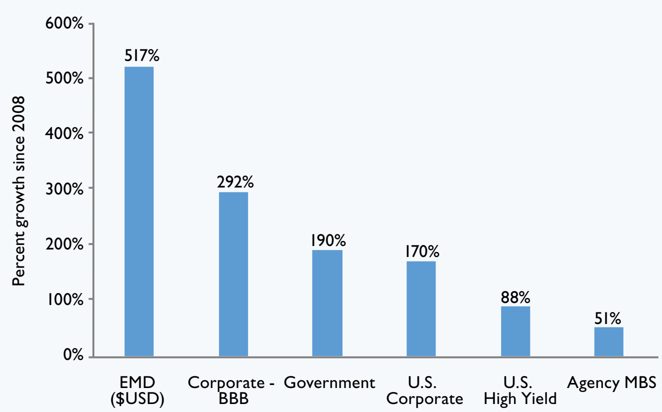
Global debt growth

Corporate debt and other asset classes have experienced significant growth since the global financial crisis



Source: Bloomberg Barclays, as of May 21, 2019.

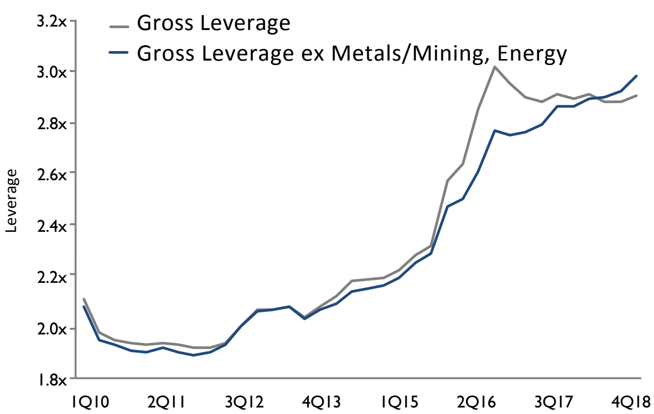
Debt growth has been substantial



Source: Bloomberg Barclays, as of May 21, 2019. Measured over time period 1/1/2008-5/21/2018.

No bank guarantee • May lose value • Not FDIC insured

Chart 1: Corporate leverage is at historically high levels

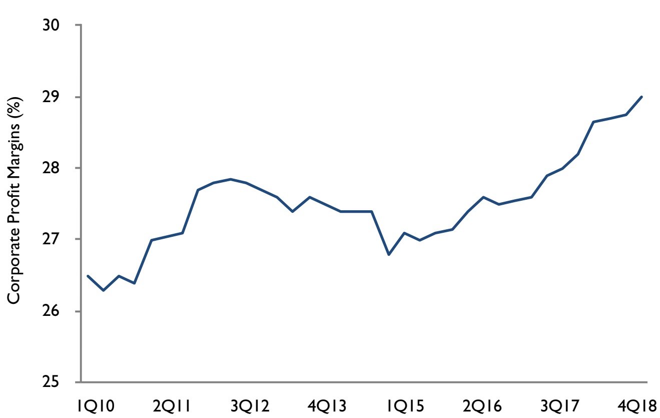


Source: JP Morgan, as of December 31, 2018.

Despite these concerns, there are significant positives still in place. Profit margins and cash flows remain at all-time highs in most sectors (Chart 2). However, we are seeing exceptions in certain industries. Liquidity is also sound and low-interest rates have allowed companies to push out maturities. Also, larger companies with significant asset bases, such as General Electric (GE), will be able to use assets as liquidity to satisfy debt requirements.

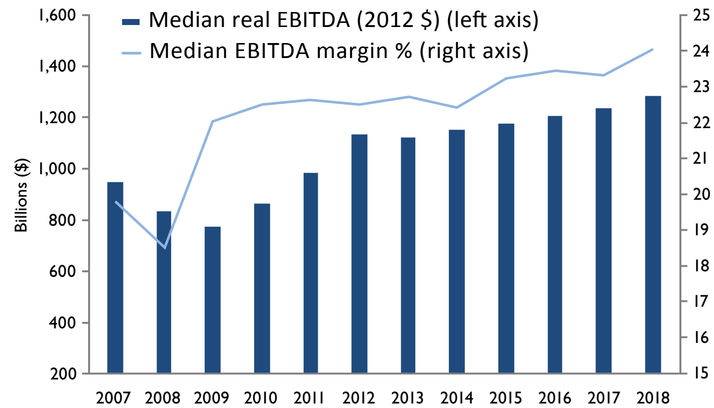
Overall, we have become more cautious within the BBB space, and believe industry and credit selection play a key role. Our strategy is to be very selective and invest in companies we believe can improve their capital structures.

Chart 2: Profit margins are a positive for corporate credit



Source: JP Morgan, as of December 31, 2018.

Chart 3: EBITDA growth is steady



Source: Moody's Investor Services, as of January 31, 2019.

What effect have these concerns had on the BBB corporate bond market?

Some single A rated companies have been downgraded to BBB post-mergers and acquisitions (M&A) transactions, as they are willing to pay, on average, an additional 30 to 40 basis points (bps) funding cost to make a strategic acquisition. However, post downgrade, fundamentals take the driver's seat. Investors have realized that companies saddled with a significant amount of leverage are not always able to achieve growth and profitability to meet deleveraging goals. These companies will be at risk of further downgrades. Investors demand a higher risk premium to compensate for potential credit spread widening and downgrades, resulting in high volatility of these companies' bond prices.

Do you think the rating agencies are approaching this correctly?

Not completely. Allowing a significant amount of investment-grade companies to be leveraged like high-yield companies is a problem. Not only are more leveraged names dealing with various issues that drove them to make acquisitions, they are carrying a larger debt load while having to work through complex integration issues.

While we do not think there will be a large wave of fallen angels, the amount of leverage clearly creates a higher probability for idiosyncratic risk where the current risk-return tradeoff benefits the issuer and not the investor. At the very least, increased leverage in the system has the potential to create higher volatility, as witnessed in late 2018 and so far in 2019.

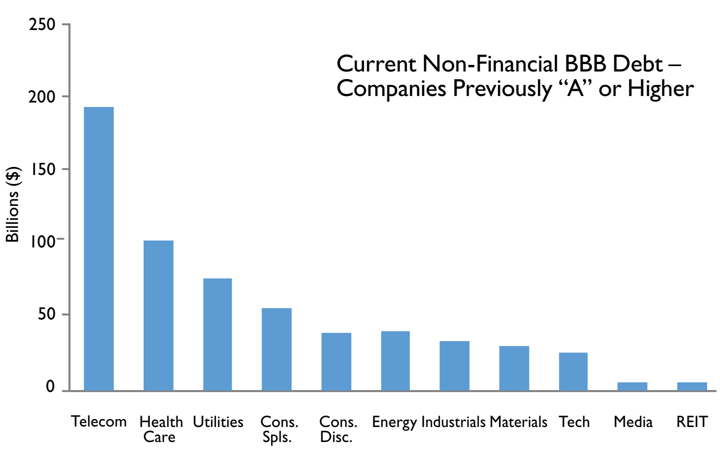
Are there opportunities for the investor?

Yes. During risk-off periods, markets may overreact and throw all BBBs "out with the bathwater." We are able to take advantage of this because of our selective focus on individual companies. For example, Anheuser Busch was a company struggling to grow into its M&A-induced, debt-laden balance sheet. This massive beverage stalwart saw its bonds underperform and began to trade like a low BBB after getting downgraded in the fourth quarter of 2018. Post downgrade, we added exposure to the company after Anheuser Busch responded with very credit friendly decisions, including cutting its dividends and announcing a plan to clear out near-term maturities. Anheuser Busch bonds have performed well since.

Are there sectors that concern you?

Yes. Increased debt in companies that have migrated from A to BBB is concerning. We have seen debt growth in sectors such as telecom, healthcare, food and beverage, and consumer products (Chart 4). Our team has been cautious in many of these sectors, mainly for the reasons driving M&A—lack of growth, margin pressure and secular changes.

Chart 4: Debt growth in sectors from formerly A rated issuers



Source: Morgan Stanley, as of October 5, 2018.

Are there sectors you favor?

There are sectors that exhibit certain characteristics we like to see when investing, including organic revenue growth (which takes pressure off management teams to engage in M&A and share buybacks); balance sheet momentum; and debt-minded management teams that understand equity investors are not the only piece of the financing puzzle. A few of the sectors where we are finding attractive bonds include midstream energy, REITs and U.S. banks.

Table 1: 20 largest BBB issuers account for more than 33% of total debt with many formerly A rated

Company	Rating	Total Debt ($bn)	Highest Prior Rating
AT&T	Baa2	183,418	Aa3
Verizon	Baa1	112,942	A1
AB InBev	Baa1	109,914	A3
GE	Baa1	64,631	Aaa
CVS	Baa2	62,886	A2
United Tech.	Baa1	38,367	A2
Kinder Morgan	Baa2	37,605	Baa3
AbbVie Inc.	Baa2	37,506	Baa1
Amgen Inc.	Baa1	34,427	A2
McDonalds	Baa1	31,895	Aa2
Kraft Heinz	Baa3	31,403	Baa2
Ford	Baa3	27,342	A1
Enterprise Prod.	Baa1	25,914	Baa1
Allergan	Baa3	23,583	A3
Abbot Labs.	Baa1	23,347	Aa1
Union Pacific	Baa1	22,411	A3
Williams Co's.	Baa3	21,442	Baa2
Celgene Corp.	Baa2	20,350	Baa2
PPL Corp.	Baa2	20,254	Baa2
Mondelez Int.	Baa1	19,920	A2

Source: Moody's, Bloomberg Barclays as of September 30, 2018.
Note: AB Inbev was downgraded on 12/10/2018. AB Inbev total debt as of 12/31/2018.

How significant is the downgrade threat?

At first glance, the threat looks large. At $2.5 trillion, BBB debt is more than two times the size of the entire high-yield market, and BBB issuers are more leveraged than they have been in recent memory. However, we don't think a systematic wave of downgrades from BBB to high yield is realistic. There will be individual BBBs that are not able to meet their deleveraging targets and will be downgraded to high yield. We may also see stress in certain sectors that have experienced a lot of leveraging (as was the case with commodity sectors in 2015).

We believe investors who are selective with credit risk can benefit from owning large, liquid and stable BBB names that focus on increasing margins and using excess free cash flow for debt reduction. Recently, we are seeing more examples where management teams are realizing that further downgrades would be detrimental to their competitive advantage. An increasing number of large cap issuers such as Anheuser Busch, AT&T, and Verizon are realizing that downgrades would be detrimental to even the performance of their equity.

Over the next year, are there any large BBB names that you have downgrade concerns over?

It's not a huge list. Ford is a possibility, but we think it's a low likelihood that it will be downgraded to high yield by more than one rating agency in the near term. Newell Brands, an overly leveraged M&A corporation, and Edison International, hurt by the California wildfires, are also potential candidates. Pharmaceutical company Mylan, another serial M&A player, is also a lower probability candidate. Collectively, these four companies have approximately $53 billion in investment-grade rated bonds.

What do you look for to avoid fallen angels?

There are two primary features we look for: The first is a commitment to be investment grade. Sectors such as midstream energy have shown the willingness to protect their cash flows in the most stressful time periods. The second is to have an ability to maintain investment-grade rating characteristics by growing organically to bring down leverage, selling assets, issuing equity and/or cutting dividends and pausing share repurchases.

Can you discuss the credit performance of the investment-grade market in the fourth quarter of 2018 versus this year?

We had significant volatility in the fourth quarter of 2018 and in the first quarter of this year. But unlike other risk assets, the investment-grade market had been dealing with this volatility for most of 2018 as a result of rising interest rates. The negative-return impact of higher interest rates in early 2018 caused mutual fund investors to rotate away from investment grade. Highershort-term rates also kept foreign buyers at bay due to increased hedging costs. Volatility spiked in fourth quarter 2018 as recession fears piled onto an already stressed investment-grade market, with BBBs taking the brunt of the sell-off (BBBs widened 73 bps in 2018 versus 54 bps for the entire Bloomberg Barclays U.S. Credit Index).

This sell-off created a significant amount of relative value. As fears of a recession, poor earnings, and mass downgrades to high yield subsided in the first quarter of this year, credit investors (mutual funds and foreign buyers) stepped back in the market. As a result, credit spreads rallied significantly, chalking up one of the best performing quarters in past 10 years.

How much room remains for BBB rated bonds to further outperform and fully close their fourth quarter 2018 performance gap?

Through April, BBB rated bonds have recovered most of their underperformance from the fourth quarter of 2018. Technicals (foreign demand, positive returns, lower net supply) within the investment-grade universe remain strong due in part to a patient Federal Reserve (Fed) policy backdrop. But for the group as a whole to continue outperforming, existing macro shocks—including Fed policies, trade wars and Italian debt—will need to remain limited. If not, companies with high debt burdens will be challenged to delever in a slowing economy. Credit spreads of companies in sectors exposed to potential political policy changes such as healthcare and tobacco are also likely to remain under pressure.

We do believe that some select BBB rated companies will continue to outperform by delevering through successful integration, achieving synergies and using free cash flow to meet leverage targets.

What are your takeaways for investors?

We do not think BBB corporate bonds as a whole will pose a systematic risk to the broad financial market since some of the largest credits have the incentive and resources to prevent their credit rating from dropping below investment-grade levels. Some BBB companies face greater challenges in delevering, while others that proactively improve profitability and reduce debt will likely outperform. We believe the spoils go to selective, active investors.

Definitions

Agency Mortgage-Backed Securities (Agency MBS) is represented by the Bloomberg Barclays Mortgage-Backed Securities Index, which is a market value-weighted index composed of agency mortgage-backed pass-through securities of the Government National Mortgage Association (GNMA, and called Ginnie Mae), the Federal National Mortgage Association (FNMA, and called Fannie Mae), and the Federal Home Loan Mortgage Corporation (FHLMC, and called Freddie Mac) with a minimum $150 million par amount outstanding and a weighted-average maturity of at least one-year.

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.

EBITDA, or Earnings Before Interest, Tax, Depreciation, and Amortization, is a measure of a company's profits before any of these net deductions are made.

EM USD Aggregate is represented by the Bloomberg Barclays Emerging Markets USD Aggregate Index which is composed of fixed and floating-rate U.S. dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate emerging-market issuers.

Government is represented by the Bloomberg Barclays Government/Credit Bond Index, which includes U.S. dollar-denominated U.S. Treasuries, government-related, and investment grade U.S. corporate securities.

Real Estate Investment Trust ("REIT") is a type of equity security that pools investors' funds for investment primarily in income-producing real estate or in loans or interests related to real estate and often trades on exchanges like a stock.

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

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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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