Portfolio Manager Viewpoints

The drop in long-term yields was the story for the first half of 2014, as credit assets took a back seat to the performance of duration based assets. In recent months, plunging commodity prices, concerns around global growth, and diverging central bank policy have shifted focus into credit markets. In this commentary, Portfolio Managers Jason Rosiak, Brian Robertson, and Michael Lonia discuss the market environment, outlook, and positioning.

Start at the top, assess the 2014 market environment

Rosiak: In the past few months, the world has repriced for slower growth while the Fed is communicating tighter policy amidst a steadily improving U.S. economy. The U.S. has been successful in exporting many things over the decades, and 2014 was about the exporting of our monetary policy. Central bankers in Europe and Asia are attempting to debase their currencies via the acceleration of quantitative easing programs in an effort to revitalize their economies and avoid the pull towards recession and the more feared deflation. This has led to substantial outperformance of duration based assets in 2014 thus far.

Table 1: Duration outperforms in a reversal of 2013 returns

<table>
<thead>
<tr>
<th>Index</th>
<th>Duration</th>
<th>YTD Return</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate</td>
<td>7.08</td>
<td>6.68</td>
<td>-1.53</td>
</tr>
<tr>
<td>Agency MBS</td>
<td>4.54</td>
<td>5.67</td>
<td>-1.41</td>
</tr>
<tr>
<td>Aggregate</td>
<td>5.47</td>
<td>5.37</td>
<td>-2.02</td>
</tr>
<tr>
<td>Treasury</td>
<td>5.35</td>
<td>4.34</td>
<td>-2.75</td>
</tr>
<tr>
<td>High Yield</td>
<td>4.23</td>
<td>4.01</td>
<td>7.44</td>
</tr>
<tr>
<td>Bank Loans</td>
<td>0.25</td>
<td>3.04</td>
<td>6.15</td>
</tr>
</tbody>
</table>

Source: Barclays, Credit Suisse as of November 24, 2014

What is your view on the move lower in longer-term interest rates and the Fed policy on shorter-term rates?

Lonia: Interest rates can be seen as a forecast on future growth and inflation. Entering 2014, the 10-year Treasury was at 3% and expectations were for continued solid GDP growth with slowly rising inflation. However, the structural challenges of the post-Great Recession economy have resulted in a slower recovery than originally fore-
casted for 2014. Rates were also impacted by deflation fears out of Europe, concerns of a slowdown in China, net negative Treasury issuance, and additional accommodative monetary policy out of the ECB and Bank of Japan.

Robertson: With the tapering of QE completed, the focus is now on the Fed's forward guidance and the move away from the zero interest rate policy (ZIRP). General forecasts are for a mid-2015 rate hike. Given economic conditions, output, and inflation, the Fed may be in a situation that may not provide for a summer rate hike. The Fed has also been more vocal regarding the interdependence of global economic, inflation, and monetary policy actions impacting U.S. policy. This further biases for an extension of ZIRP and may impact what the neutral Fed funds or the terminal rate may be in this cycle.

Chart 1: The plunge in global bond yields, notably Europe and Japan, continue to weigh down U.S. Treasury Yields

Source: Barclays, as of November 24, 2014

Describe credit market performance year-to-date?
Lonia: 2014 has been the exact opposite of 2013, with the outperformance of duration over credit risk. High Yield has been an example of this, with BB rated bonds outperforming CCC rated securities as well as longer dated bonds substantially outperforming shorter maturity bonds. High yield has also been impacted by the recent volatility in cyclical sectors such as energy and metals/mining. Bank loans, with their limited duration, have continued to show relatively low volatility, but has underperformed our coupon like forecast of 4-5%.

How would you describe recent market volatility?
Rosiak: We have seen greater levels of volatility in risk assets, notably high yield, as global growth scares are resulting in lower commodity prices and an increase in risk premiums. The last few years have seen periods of sharp selloffs reverse quickly, with a high degree of correlation across sectors and securities. Recent performance though is showing a reduction in that beta trade. For example, following the mid-October selloff, many high yield sectors saw immediate snapbacks in yields and spreads. However, cyclical sectors such as Energy and Metals saw a continued deterioration in prices. We believe that going forward we are going to see large performance dispersions between sectors and securities based on their underlying earnings, growth, and valuation drivers.

Chart 2: Sectors and issuers are trading on fundamentals and growth outlooks versus the highly correlated performance of the past few years

Source: Barclays, as of November 26, 2014

Speaking of commodities, how much of an impact has the sharp drop in commodity prices had on the markets?
Robertson: The drop in commodities each have their own specific reasons, but there are some common underlying themes; a strengthening dollar, excess supply, Chinese economic weakness and global growth concerns. Given the recent expansion in energy infrastructure and shale drilling, mainly financed through the U.S. debt markets, the energy sector weighting has grown substantially in the last decade (Chart 3). Energy is a much smaller component of the S&P 500 than it is in the credit markets. This is particularly true for high yield where many of the more leveraged and higher cost operators exist. This has led to a meaningful drop in high yield prices in aggregate relative to other risk assets (Chart 4).
With credit risk taking a back seat in 2014, what about the outlook for 2015?

Lonia: Whether it is stagnant GDP growth, monetary policy conditions, or the fiscal and macro concerns, this cycle has been truly unique. If you break down the credit cycle into the monetary, economic, and business cycle dynamics, we continue to see limited inflection points that mark the end of the cycle. The current mix of the three dynamics remains favorable to credit cycle extension, despite now being in the 67th month.

Rosiak: The 12-month trailing default rate for bank loans and high yield bonds was 0.91% and 0.59% respectively, excluding TXU (Source: JP Morgan). It is likely that defaults rise in 2015 from these very low levels given certain sector risks and the impacts of diverging monetary policies, earnings, and growth outlooks. We are not expecting a surge in defaults by any means, but more of a move off of the bottom of what has been an extraordinarily low default environment. Given that, the environment still remains conducive to the default rate remaining well below historical levels.

We have seen a good pick up in M&A financing and acquisition related new issuance, which some view as an inflection point?

Lonia: The macro environment has produced strong M&A activity given favorable capital market conditions coupled with lackluster organic revenue growth. M&A activity is up 25% in the past two years with a heavy focus in the TMT, Retail, Healthcare, and Utilities/Energy space. We expect M&A activity to accelerate into 2015 with the energy sector a potential hotspot as companies look to cut costs if price declines persist. Also, we are seeing companies find creative ways to add value through breakups, such as the long awaited breakup of Hewlett Packard.

We see today’s M&A activity driven by the necessity for strategic acquisitions due to lack of organic growth. This is in contrast to the capital destructive behavior of the 2005-2007 periods and the LBO boom, led by PE sponsors aggressively leveraging companies and capital structures which proved to be the peak of the credit cycle.

How do you position portfolios for 2015?

Robertson: We believe there are three themes entering 2015 that will likely drive performance and our positioning. First, market volatility is likely here to stay as diverging central banks, economies, growth prospects, and sector specific risks lead to higher realized volatility. Second, we are going to see a growing dispersion of returns across sectors and issuers based on their underlying fundamentals, business conditions, and growth prospects. Third, rate volatility is likely to persist given diverging central bank policies, with a bias for higher U.S. rates from today’s levels.
Chart 5: Bank loans continue to exhibit low volatility relative to high yield bonds. This has been particularly true over the past few months.

Source: Barclays, Credit Suisse, as of November 25, 2014

Rosiak: We continue to favor credit versus duration risk, despite its underperformance in 2014. This translates to portfolios being overweight spread and a down in quality bias relative to the benchmark. This is particularly true for high yield and bank loan strategies, where we find the higher yield, stable fundamentals, and more attractive pricing conducive to overweight’s in B versus BB rated issuers. For investment grade strategies, this means a significant focus on intermediate maturity BBB rated credits. We also believe investors should take another bite out of the apple with bank loans, which can substantially reduce duration risk and increase portfolio yields.

Lonia: Within multi-sector strategies, continued rate and credit volatility have led us to keep a balance of high yield bonds and bank loans. Despite the current yield advantage favoring high yield, bank loans have been a low volatility, relatively stable asset class (Chart 5). We continue to favor BB rated bank loans versus BB rated bonds, due to the current duration risk of bonds given current spread/rate levels.

Summary: 2014 has been a year of duration performance as credit took a backseat. Going forward, with diverging central bank policies, growth, and issuer specific risks, volatility is likely to be a central theme of 2015. Corporate fundamentals combined with a moderate backdrop of growth and inflation, should continue to extend the credit cycle.

Pacific Asset Management
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