PACIFIC ASSET MANAGEMENT

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THE INVESTOR Compass
NAVIGATING THE CREDIT MARKETS

Portfolio Manager Viewpoints

The post-election environment has seen a sharp rally in risk assets and economic optimism. In this note, David Weismiller, Portfolio Manager on Pacific Asset Management's investment grade bond strategies, discusses the market environment and current positioning.

The market has changed, discuss the post-election environment.

Weismiller: Prior to the election, we felt the economy and corporate earnings were gaining momentum. Since the election, expectations of fiscal stimulus, tax reform, and regulatory rollbacks have improved sentiment. This optimism, along with improved economic and earnings outlooks, have been major catalysts driving risk assets higher (Table 1). With markets pricing in a lot of positive news, the short term driver of market performance will most likely be whether sentiment is validated by policy action.

Table 1: Risk assets continue to lead

Index	Return since 11/8	1-Year return
S&P 500	11.12	18.27
High Yield	3.75	16.05
Bank Loans	2.74	9.73
Int Corporate	-0.47	2.89
Corporate	-0.72	3.80
Agency MBS	-1.42	0.34
Aggregate	-1.44	0.81
Treasury	-2.08	-1.05

Source: Barclays, Credit Suisse, as of March 28, 2017

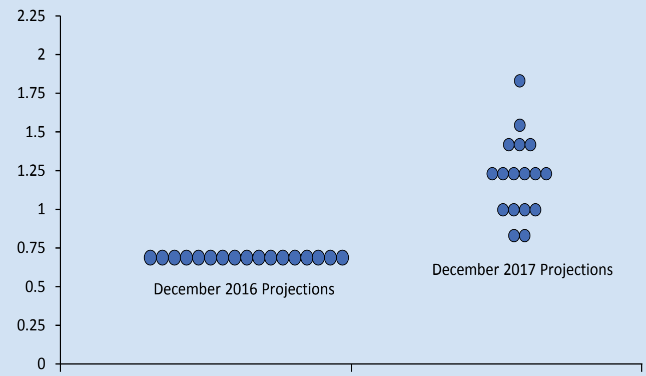
How do you assess the economic outlook? Are we poised for a sharp upturn in GDP?

Weismiller: Our outlook on the U.S. economy and corporate earnings is much improved from last year. While economic benefits from policy change may take some time; consumer and business sentiment measures have reached 15-year highs. Sentiment can be self-fulling as companies pull forward demand in anticipation of higher growth and become more comfortable putting capital to work, i.e. capital expenditures. While we don't anticipate a "sharp"

Curve flattening

Despite expectations for the fed to raise the target rate 2-3 times in 2017...

Federal Reserve "Dot Plots" for 2017

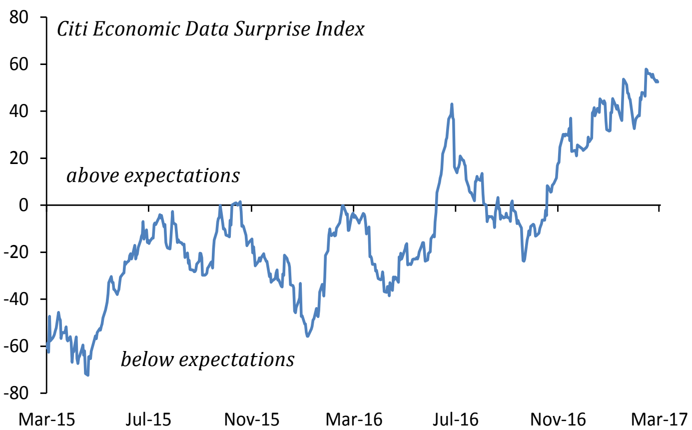


Source: FOMC, as of December 31, 2017

Long-term U.S. Treasury yields have been largely range bound since November

Source: Barclays, as of March 31, 2017 upturn in GDP, we expect continued positive economic momentum as supported by what we're seeing in the new orders index, hiring surveys, and ISM manufacturing.

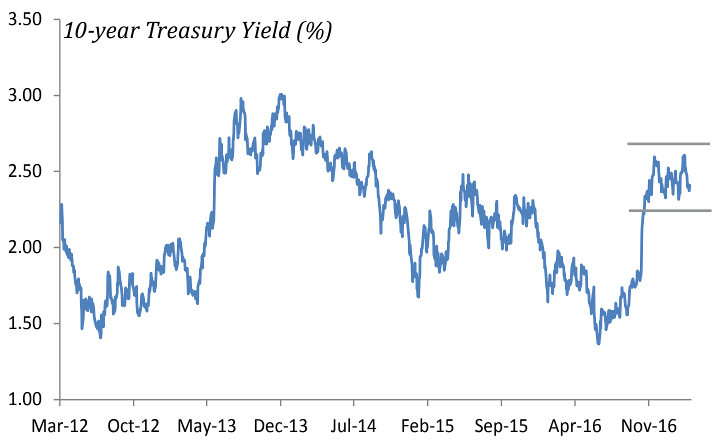
Chart 1: Improving economic data has supported risk assets since mid-2016



Source: Bloomberg, as of March 27, 2017

While the yield curve may be a bit distorted by monetary policy, longer maturity Treasuries are a key forward looking indicator of growth and inflation. Following the election in November, Treasury yields surged given the renewed growth and inflation expectations (Chart 2). However, since the initial adjustment to a year-end yield of 2.43%, the 10-year Treasury yield has been range bound. This is despite improving economic data, increasing inflation measures, and a Fed rate hike. To us, this translates to a bond market that is cautious on an acceleration of growth and the ability of the new administration to achieve all the regulatory and fiscal policy desires.

Chart 2: Treasury yields have been range bound after the November election spike



Source: Barclays, as of March 28, 2017

What is your outlook for monetary policy?

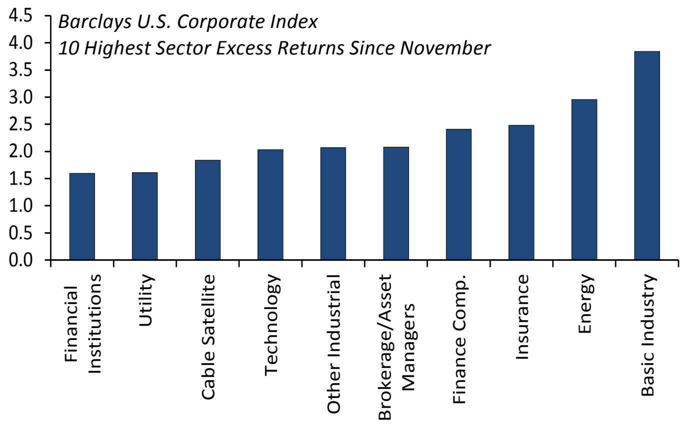
Weismiller: After two years of "one and done" in December, the Fed raised the fed funds target rate by 25 basis points in March and signaled two more hikes in 2017. Although we believe two more rate hikes may be warranted this year, the Fed may err on the cautious side of this projection. I believe they will continue to be data dependent and not try to front run expected fiscal policy. Post 2017, I think it's doubtful the Fed will be able to move in line with the projected hikes in 2018 and 2019.

For the markets, this means that as the Fed tightens policy, short term rates should steadily move higher, and volatility in long term rates may pick up. As the fed shifts away from monetary stimulus, fiscal stimulus is expected to fill some gaps. However, headwinds for long-term growth, including shifting demographics, euro-area instability, and broadly restrictive banking regulation, should remain. I also expect the positive technical for longer-term assets from foreign purchasers and defined benefit plans to continue. So while the Fed will begin its road towards normalizing their policy, the aforementioned factors should help keep a bit of a lid on long-term rates.

Let's narrow in on U.S. credit. What has been the market performance post-election?

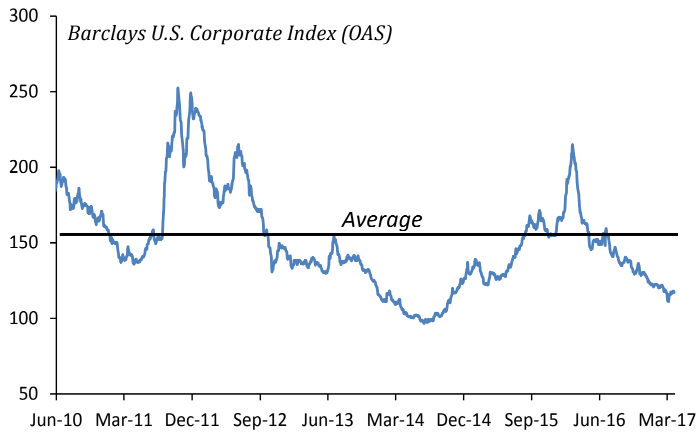
Weismiller: Corporate bonds have benefited from the favorable fundamental and technical backdrop, exhibiting strong excess returns over Treasuries and other government-related asset classes. The rotation in sector leadership has been towards companies viewed to benefit more from the new administration's focus on deregulation; Energy, Metals/Mining, Banks, and Financials, have seen meaningful excess returns. Additionally, many capital goods and industrial sectors that may benefit from fiscal stimulus and infrastructure spending have also performed well, while more interest rate sensitive sectors have underperformed.

Chart 3: Corporate sectors with highest excess returns since November



Source: Barclays, incorporates the five month trailing period ending March 27, 2016. Basic Industry includes Metals/Mining sector.

Chart 4: Corporate bond spreads have moved towards the lower end of the post crisis cycle



Source: Barclays, as of March 27, 2017

Assess the current fundamental, technical, and valuation environment for U.S. credit.

Weismiller: Investment grade companies are currently running with historically high levels of leverage. This has been the result of two main factors 1) cyclical sectors such as Energy and Metals & Mining entering earnings troughs and 2) increased debt-funded M&A over the past two years as the combination of low growth and borrowing costs fuel corporate debt issuance. Despite this, a better picture of corporate health is emerging. Earnings growth in the Energy and Metals & Mining sectors is helping these companies to de-lever. Also, corporate M&A activity has slowed and we have witnessed management teams paying down debt post their respective M&A combinations. Away from the balance sheet, corporate cash flows and liquidity levels remain robust.

From a technical perspective, the significant demand for U.S. corporate bonds has provided a favorable tailwind. With negative interest rate policies abroad and systemic risks in Europe, U.S. credit has seen record setting demand over the past few years. We believe this will continue.

From a valuation framework, after the strong move lower over the past few months, Option-Adjusted Spread (“OAS”) levels are towards the tights of the post 2009 range (Chart 4). This leads us to focus on higher quality credits and companies that are able to execute on their de-leveraging plans. Should interest rates move higher, investors have some insulation due to the incremental spread from these issues.

Describe your current positioning.

Weismiller: From a top-down perspective, the landscape looks accommodating for our corporate issuers and we are broadly in-line with benchmarks on an OAS basis given current valuations. We believe BBB-rated corporate bonds provide the greatest risk/reward in investment grade fixed income. Thus, we continue to be overweight, but remain selective.

There are a few important themes in our strategies. We are focused on U.S. companies with domestic revenue streams given a favorable outlook on U.S. growth. Since the election, our conviction around “staying home” in terms of corporate profits continues to strengthen, especially given potential tax cuts, repatriation, and uncertain trade policies, all combining for a more favorable U.S. economic cycle.

We have been, and continue to be overweight U.S. banks and financials and, while we have reduced that overweight post-election, find them as attractive core holdings. This view is in contrast to Euro-area bank counterparts who we find many to have unattractive valuations and margins of safety given systemic concerns. We are underweight sectors that continue to see shareholder friendly activity and M&A which pose a risk to bond holders. We find this most relevant in Healthcare and Technology, where industry wide consolidations and releveraging are taking place.

For strategies that incorporate non-investment grade sectors, we find bank loans to have risk-adjusted relative value when compared to high yield. While BB/B yields are near equivalent for the two asset classes, the limited duration risk and lower volatility of bank loans is currently attractive.

You didn't mention retail.

Weismiller: Retail will have a lot of headlines this year and in the future as there may be quite a few brand names either stripped of their investment grade rating, or even restructured via bankruptcy. While retail accounts for only around 4% of the Barclays Corporate Index, the heightened media attention and name recognition will put this top of mind for many investors. We have had significant underweights to many of the brand name retailers given their secular headwinds, likelihood of downgrades, and ongoing stress on their balance sheets. Many management teams will find themselves choosing between supporting their strong credit rating or their stock price. Despite our negative outlook, we have found value in a few organically growing credits in the specialty, discount, and drug store spaces.

Summarize the outlook and investment positioning.

Weismiller: Improving economic data and the prospects of fiscal stimulus, tax reform, and less regulation have led to excess returns for corporate credit to start 2017. Given stable corporate health and economic data, we expect this to continue in the short-term. While spreads have compressed, the relative yield advantage provided by corporate bonds remains favorable in our view and should help protect investors against rising interest rates relative to government-related securities. While we are finding value in select sectors and individual credits, current valuations leave us leaning slightly defensive.

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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 and a wholly owned subsidiary of Pacific Life Insurance Company. As of March 31, 2017 the firm managed $6.2bn.

FOR MORE INFORMATION

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