PACIFIC ASSET MANAGEMENT

DECEMBER 2017

THE INVESTOR Compass
NAVIGATING THE CREDIT MARKETS

Twelve for '17

Our twelve charts for 2017, a year in which almost everything "worked". Steady global growth, employment gains, corporate tax cuts, and normalizing interest rates without inflation helped continue the economic optimism and thus, favorable market conditions for risk assets. Arguably the most remarkable dynamic of this year's rally has been the absence of volatility, further fueling sentiment and prices.

Credit returns were strong, but not spectacular, as high yield returned a little above coupon in 2017, with loans more "coupon-like". Investment grade credit benefitted from both spread tightening and curve flattening, with long-dated assets significantly outperforming. What underperformed? Retail. The sector saw an acceleration of defaults and downgrades given evolving secular forces, technology, and downward pricing pressures.

Further stabilization of corporate profits and improved global growth provided a fundamental catalyst to the risk-on market environment. Issuers also took advantage of the wide open capital markets with record gross issuance across most credit sectors in 2017.

Table 1: Credit and duration risk performed well in 2017

Index	Duration	Yield	2017 Return
High Yield	3.86	5.72	7.50
Corporate	7.58	3.25	6.42
Bank Loans	0.25	5.72	4.25
Int Corporate	4.40	2.88	3.92
Aggregate	5.98	2.71	3.54
Agency MBS	4.43	2.91	2.47
Treasury	6.23	2.19	2.31

Source: Barclays, Credit Suisse, as of December 29, 2017

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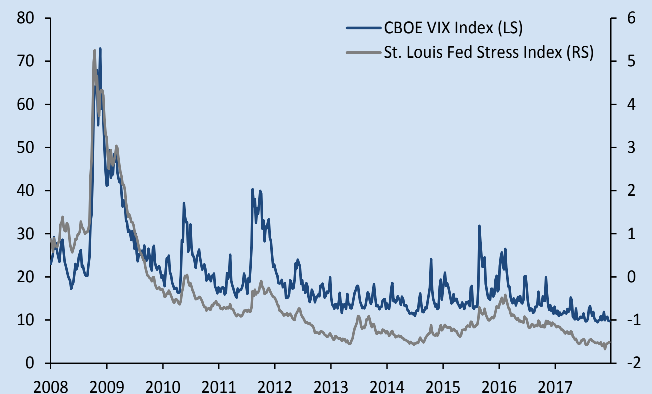
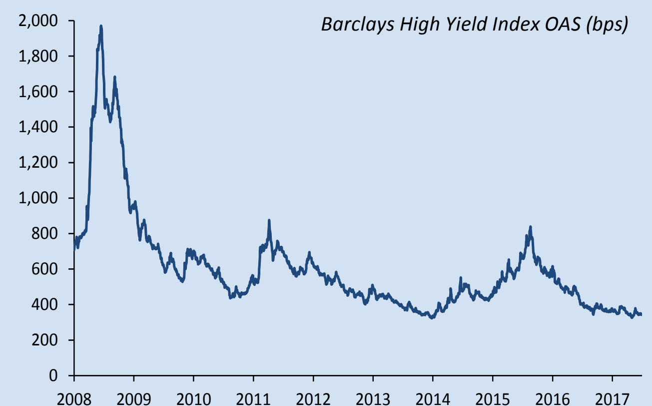
Remarkably absent

Volatility's absence was a big part of 2017, helping to drive lower risk premiums, record market issuance, and continued credit performance.



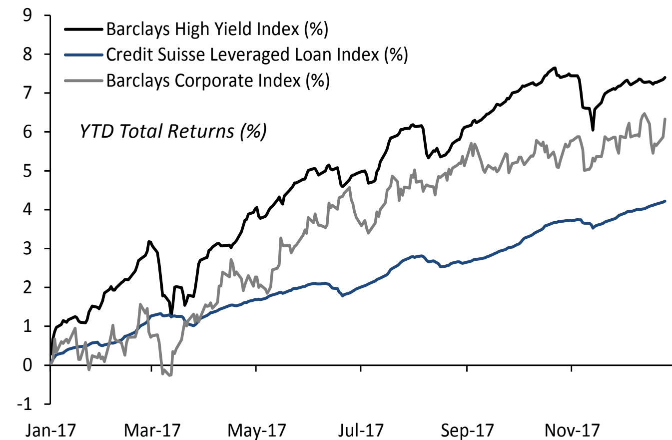
Source: St. Louis Federal Reserve, as of December 27, 2017

Low volatility also helped drive high yield bond spreads to the lowest part of the range since 2010



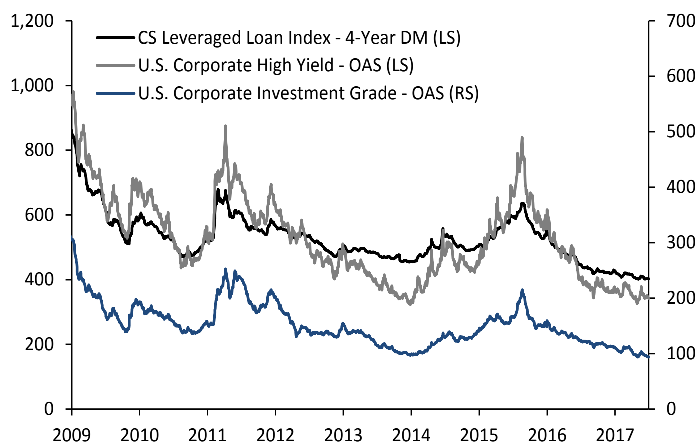
Source: Barclays, as of December 27, 2017

Chart 1: Selloffs in credit proved temporary as risk assets moved higher through the year



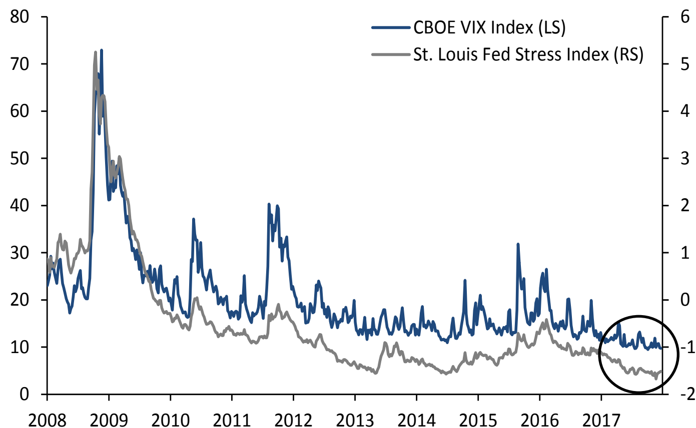
Source: Barclays, Credit Suisse, as of December 27, 2017

Chart 2: The favorable market environment moved spreads to the lowest part of the range seen since 2010



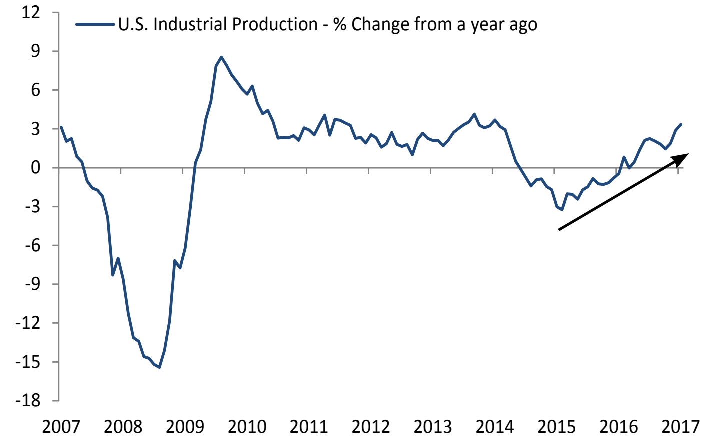
Source: Barclays, Credit Suisse, as of December 27, 2017

Chart 3: Volatility moved to record lows



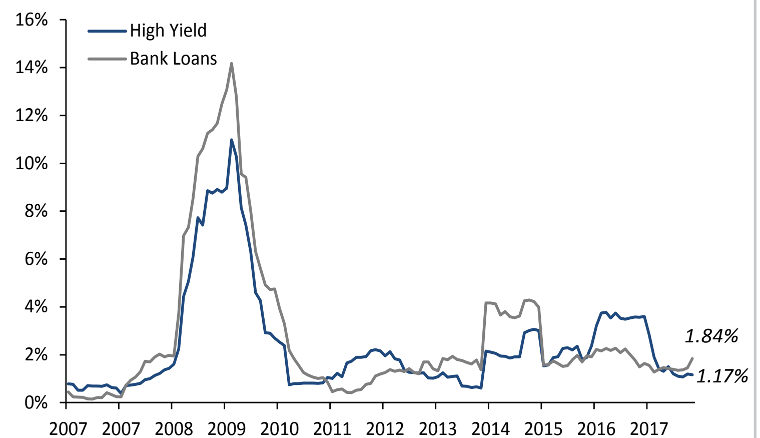
Source: St. Louis Federal Reserve, as of December 27, 2017. The St. Louis Fed Stress Index measures the degree of financial stress in the markets and is constructed from 18 data series.

Chart 4: The improvement in U.S. economic activity supported the fundamental case for valuations



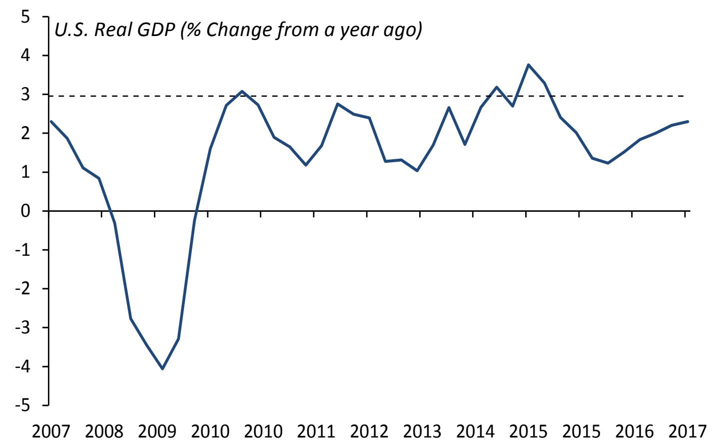
Source: St. Louis Federal Reserve, as of December 1, 2017

Chart 5: Default rates remain low



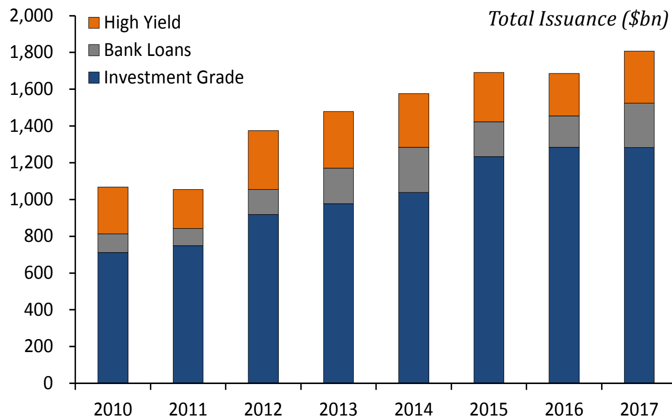
Source: JP Morgan, as of December 1, 2017

Chart 6: Can the economy cross 3%?



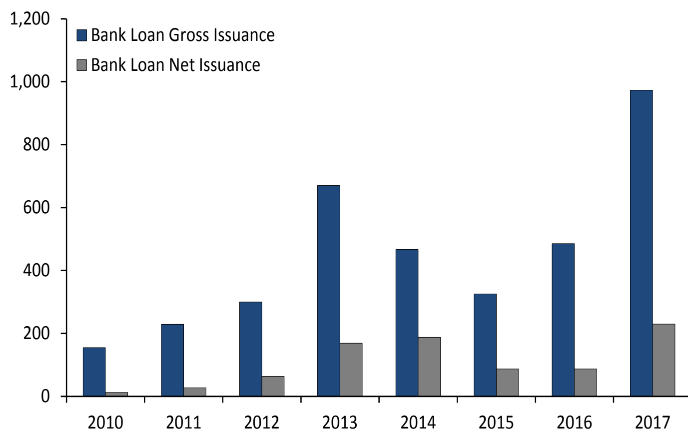
Source: St. Louis Federal Reserve, as of October 1, 2017

Chart 7: 2017 saw record issuance across U.S. credit markets



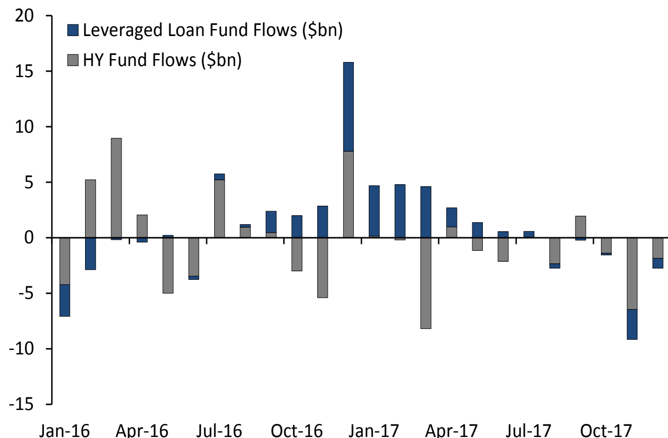
Source: DB, JP Morgan, as of December 1, 2017

Chart 8: Bank Loan Issuance was particularly strong, though the majority of issuance was for refinancing



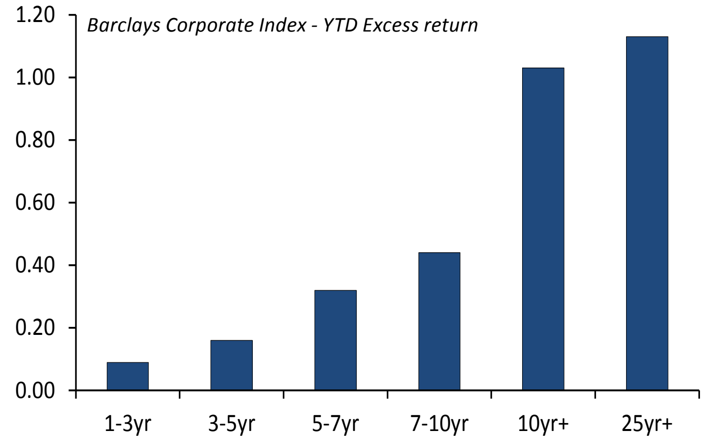
Source: JP Morgan, as of December 29, 2017

Chart 9: Despite strong sentiment, fund flows showed market participants' caution towards the rally



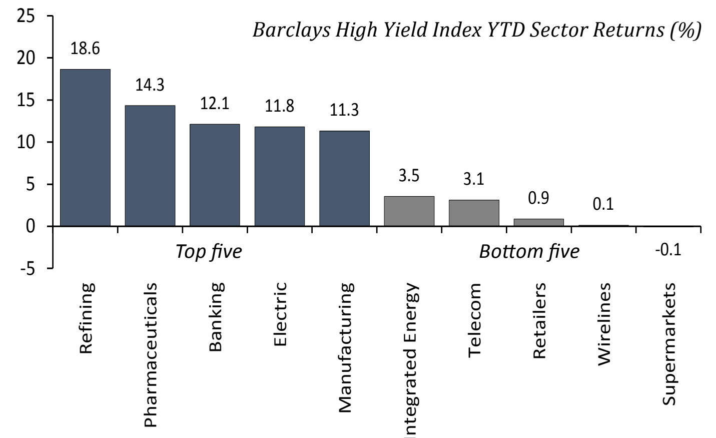
Source: JP Morgan, as of December 21, 2017. Includes both mutual fund and ETF's.

Chart 10: A flatter yield curve and strong technical demand led to meaningful outperformance of longer maturity corporate bonds



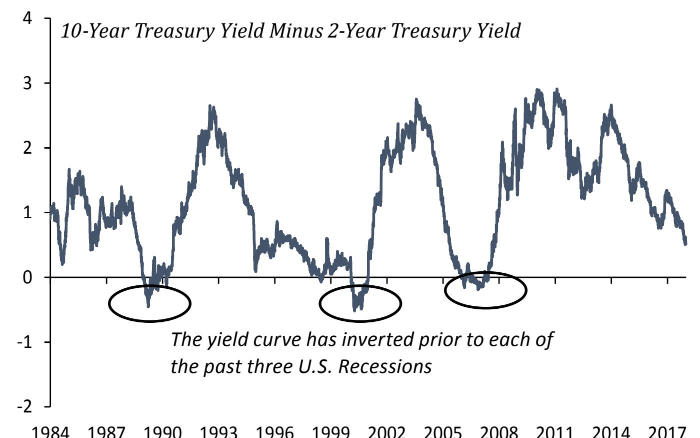
Source: Barclays, as of December 29, 2017

Chart 11: The reflation trade experienced the strongest performance in 2017. Sectors going through technological, secular, and competitive pressures underperformed.



Source: Barclays, as of December 29, 2017

Chart 12: Continual tightening by the Federal Reserve increased short term rates, resulting in a flatter yield curve. Both the Fed and the yield curve will be important to monitor in 2018.



Source: Barclays, as of December 29, 2017

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With market sentiment and valuations at or near historic highs, what may present itself as a headwind in 2018? Annualized U.S. GDP remains at a sub 3% growth rate, yet the Federal Reserve has begun increasing short-term rates and unwinding its balance sheet. Whether positive growth sentiment will result in an acceleration of economic activity remains to be seen. If growth remains range bound in the 2% level experienced over this most recent cycle, a repricing of credit risk may bring a return of volatility. The recent passing of tax reform may serve to provide this stimulator to economic growth, though we are cautious regarding the impact of fiscal stimulus on a somewhat tired business cycle. We remain cognizant of the debt market's historic levels and the optimism priced into risk assets on the back of fiscal, tax, and regulatory reform.

The Federal Reserve continues on its path of policy normalization. Tightening by the Federal Reserve increased short term rates, resulting in a flatter yield curve. Both the Fed and the yield curve will be important to monitor in 2018.

As we close 2017, we find ourselves slightly cautious and modestly underweight risk 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. However, with yields moving towards the lower part of the range seen this decade, we prefer to remain cautious and would welcome a return of volatility. Another concern is towards current market sentiment not accounting for possible external shocks that could bring a reassessment of valuations. We believe a failure of fiscal stimulus or exogenous shocks could lead to an increase in volatility, providing opportunities to re-assess our risk.

Pacific Asset Management
December 2017

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 December 31, 2017 Pacific Asset Management managed approximately $8bn.

IMPORTANT NOTES AND DISCLOSURES
Bank loan, corporate securities, and high yield bonds involve risk of default on interest and principal payments or price changes due to changes in credit quality of the borrower, among other risks. Pacific Asset Management is an investment advisor; it provides investment advisory services to institutional clients and does not sell securities.

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FOR MORE INFORMATION
Pacific Asset Management • 700 Newport Center Drive • Newport Beach, CA 92660 • www.pacificam.com