



PACIFIC FUNDS

PERSPECTIVES

MID-YEAR OUTLOOK
JULY 2017



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

Uncertainty was a major theme in the first half of 2017, which had a pronounced impact on the financial markets. In times like these, it's important to work with investment managers who are experienced at navigating these markets.

We believe active management around the tailwinds and headwinds that affect growth will have important investment implications for the remainder of 2017.

tailwind

noun tail•wind *\ˈteɪl-wɪnd*

A condition or situation that will help move growth higher.

headwind

noun head•wind *\ˈhed-wɪnd*

A condition or situation that will make growth more difficult.

TAILWINDS

The first half of 2017 saw a continuation of the risk-friendly market environment, which led to strong total returns from equity and credit-related asset classes. Strong momentum from economic data, corporate earnings, and an absence of volatility have supported this risk appetite. The so-called “reflation trade,” which are those investments benefiting most from possible fiscal reform and growth sentiment, have seen the strongest total returns. Within credit, high-yield bonds have 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. Corporate-health measures have provided a favorable bottom-up backdrop as earnings, business, and sentiment measures, as well as manufacturing activity are supporting current spreads.

HEADWINDS

Despite the surge in confidence measures and corporate health, first-quarter U.S. gross domestic product (GDP) annualized growth came in at 0.7%, which was then revised to 1.2%. This low GDP growth has led to concerns that despite the surge in “soft” data measures such as sentiment, economic growth remains in a 2% range, which has defined this business cycle. While the first-quarter GDP reading is historically weak given weather and seasonal-related distortions, this last reading was one of the lowest in the past three years.

There are signs, however, of an improved outlook for the second quarter. Much of the “hard” data for consumption and investment may be catching up to the “soft” data within sentiment and surveys. The Federal Reserve Bank of Atlanta GDPNow™ forecasting model¹ currently estimates a 3.0% second-quarter GDP reading. This is a strong rebound from the first quarter, but annualized readings remain well within the 2.0% GDP range seen during the past few years.

POTENTIAL INVESTMENT IMPLICATIONS

As we enter the second half of 2017, we find opposing forces leading to generally risk-neutral positioning. A favorable fundamental backdrop (anchored by stable corporate health) coupled with a positive technical backdrop (driven by investor demand for yield) gives an attractive bottom-up view of U.S. credit. Given the favorable outlook, we recognize the current rally in equity and credit-related asset classes may have further to go. However, too much optimism may be priced in given the ability of fiscal reform to translate to higher economic growth rates than previously experienced during the past few years. Current market sentiment also does not account for possible external shocks that could bring about a rekindling of volatility, thus expanding risk premiums. We believe a lack of fiscal stimulus or hints of macroeconomic shocks could lead to an increase in volatility, providing opportunities to allocate more into risk assets later in the year. 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.

¹The Federal Reserve Bank of Atlanta GDPNow forecasting model provides a preliminary estimate of gross domestic product (GDP) prior to the release of the official estimate of GDP.

TAILWINDS

Encouraging recent economic news included a revised estimate of 1.2% annualized growth in first-quarter GDP, up from the Commerce Department's earlier estimate of 0.7%. The release cited stronger-than-expected consumer spending and a less-dramatic pullback in government spending compared to earlier estimates. In the case of the former, personal consumption expenditures—the Federal Reserve's preferred inflation measure—rose 0.4% in April, reflecting a similar increase in incomes, while the personal-saving rate held steady at 5.3%.

Consumer confidence remains strong, but relatively unchanged month-over-month, according to a University of Michigan survey. The Current Economic Conditions component of the survey fell slightly, while the Index of Consumer Expectations rose 0.8% over April, and 3.3% year-over-year. Business sentiment exhibited similar characteristics, remaining strong, yet seeing little monthly change, with the Institute for Supply Management's Purchasing Managers Index increasing just 0.1% from April.

The unemployment rate fell to 4.3% in May, reaching a 16-year low. Pessimists focused on the fact that employers added only 138,000 jobs (seasonally adjusted), suggesting that the labor market is near full employment. On the plus side, the wage inflation typically associated with full employment has yet to materialize, as the Labor Department reported that nonmanagement wages rose just 2.4% from a year earlier.

HEADWINDS

Even at the revised level, GDP growth was relatively anemic in the first quarter. Consumer spending was also weak, particularly with respect to automobiles, where investors scaled back purchases even in the face of deep discounts by car makers. Nevertheless, economists and investors largely shook off the report, citing the fact that first-quarter GDP growth has been weak in recent years, only to rebound in the second quarter.

At its June meeting, the Federal Reserve (Fed) decided to raise the federal-funds rate by 0.25% and suggested that it may raise rates again by year-end if the economy performs as expected. While, in theory, higher rates could signal that inflation is on the rise, the decision did not cause market turbulence, as it was widely expected. The Fed also outlined some details of its plan to trim its balance sheet, including plans to let some bonds in its portfolio mature without reinvesting the proceeds.

While hard data on macroeconomic growth remains elusive, bottom-up data tells another story. FactSet recently revised its first-quarter 2017 earnings growth rate for companies included in the S&P 500® index to 12.5%². Such a rate of growth would be the highest since the 16.7% growth in September 2011 and the first time it has been double-digits in more than 5 years.

POTENTIAL INVESTMENT IMPLICATIONS

Concerns over both monetary and fiscal stimulus have led some to worry about the stock market's valuation. However, slow-and-steady growth may actually offer a better backdrop for the stock market than faster growth, which risks causing the economy to overheat. Our approach will be to focus on stocks with attractive relative valuations and the ability to exceed expectations.

TAILWINDS

The expectation for higher global GDP growth is likely to provide a tailwind for global equities, particularly in emerging markets, as they account for a significant portion of growth in global GDP. Potential economic reforms in the U.S. that were put on hold during the first half of the year may see new life as Congress and the White House work to put through what is, at its core, the Republican agenda. The Fed's policy path of interest-rate tightening and balance-sheet reduction is likely to steepen the yield curve and support financials that would see improving net interest margins.

HEADWINDS

The Fed represents two potential headwinds: rising interest rates for broad fixed income and the potential to tighten too quickly if inflation begins to surprise to the upside. Any unexpected tightening in the labor market would likely push inflation higher and place the Fed on a swifter course to normalizing interest rates. Valuations for U.S. stocks have been persistently moving into loftier territory in spite of more robust underlying earnings growth, which is likely to put downward pressure on future domestic-equity returns. This is especially true for growth sectors, which saw the brunt of multiple expansion, in part due to share buybacks financed by low-rate debt. It also signals potentially higher risk to equities than implied by volatility measures like the CBOE Volatility Index® (VIX®), as markets have moved into late cycle. Finally, partisan politics threaten to undermine progress on economic measures like infrastructure, deregulation, and tax reform that would otherwise boost growth and earnings for U.S. companies.

POTENTIAL INVESTMENT IMPLICATIONS

Fed policy will likely have impacts on investor sentiment in the second half of the year in spite of its intentions not to roil markets. Specifically, higher rates and balance-sheet reductions are likely to continue to put pressure on core fixed income and instead favor measured exposure to credit, lower duration, and even low-volatility alternatives that are not linked to rates. Higher rates, a steeper yield curve, and potential deregulation all favor financials, which in turn favor value over growth stocks. Late-cycle characteristics such as higher valuations and complacency indicate a higher risk to the downside and a higher-volatility regime that may finally depart from the current eerie calm. These factors favor an increased allocation to all-weather alternatives that are unconnected to traditional return sources in equities and fixed income.



ALTERNATIVES



TAILWINDS

An uptick in global GDP growth and increased infrastructure spending should boost demand for broad commodities, which in turn should benefit emerging markets. Unpredictable macroeconomic events such as central-bank decisions and negotiations over Britain's exit from the European Union may weigh on traditional equities and fixed income and give alternative strategies an opportunity to provide a differentiated return stream. Higher interest rates and tighter monetary conditions will likely put pressure on fixed income in the U.S. and across the globe, which by comparison brightens the prospects for lower-volatility alternative strategies that investors may turn to for diversification.

HEADWINDS

The greatest headwind to alternatives would be a continuation of the current low-volatility regime in which equities may continue to see outsize gains relative to their level of risk. The potential for Congress and the White House to agree on stimulus measures or other economic reforms may also dampen relative returns, as those gains would likely pass overwhelmingly to traditional equities and credit. And while unpredictable events on the global stage may present a distinct opportunity for managers of alternatives, the potential to be on the wrong side of those events places a premium on identifying managers who can demonstrate skill in positioning their strategies while managing risk.

POTENTIAL INVESTMENT IMPLICATIONS

The clearest implication is the potential for lower-volatility alternative strategies to provide a complementary return to core fixed income as interest rates increase. Emerging-market equities may also be a way to capture the uptick in global growth instead of more richly valued U.S. equities, especially given that the U.S. economy appears to be much later in the business cycle. Lastly, with inflation expectations having shifted down so far, any surprise to the upside may accelerate the Fed's pace in rate hikes, hurting domestic equities and fixed income, while boosting commodities and economies more closely linked to hard assets such as emerging markets.

WHY PACIFIC FUNDSSM

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: First Quarter 2017 (Second Estimate) Corporate Profits: First Quarter 2017 (Preliminary Estimate)." *News Releases Bureau of Economic Analysis*. U.S. Department of Commerce, May 26, 2017.

"GDPNow." *Center for Quantitative Research*. Federal Reserve Bank of Atlanta, June 26, 2017.

"Index of Consumer Sentiment." *Surveys of Consumers*. University of Michigan, May 26, 2017.

"Personal Income and Outlays, April 2017." *News Releases Bureau of Economic Analysis*. U.S. Department of Commerce, May 30, 2017.

"The Employment Situation - May 2017." *News Release Bureau of Labor Statistics*. U.S. Department of Labor, June 2, 2017.

"May 2017 Manufacturing ISM®." *ISM Report on Business*. Institute for Supply Management, June 1, 2017.

"Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents." *Monetary Policy*. Board of Governors of the Federal Reserve System, June 14, 2017.

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