PACIFIC ASSET MANAGEMENT

DECEMBER 2015

THE INVESTOR Compass

NAVIGATING THE CREDIT MARKETS

Twelve for '15

Our twelve charts for 2015. For the first time since 2008, credit markets produced negative returns. Driven by global growth concerns, weak technicals, a collapse in commodity prices, and "late stage" corporate behavior - credit risk underperformed.

At the center of this year's weakness was the outlook for the global economy. Growth concerns pertaining to China and other emerging economies deteriorated corporate profit outlooks, increasing risk premiums. Many bonds from companies with troubled balance sheets, exposure to a strengthening dollar, or the need to access capital markets had sharp drops in prices. 2015 saw the widest dispersion of sector and issuer performance since 2008.

The collapse in commodity prices, notably oil, impacted valuations and large segments of the credit market. While high yield was the epicenter of commodity related weakness (17% index exposure), bank loans and corporate bond performance was not immune.

...continued on page 4

Table 1: 2015, a year of weak returns

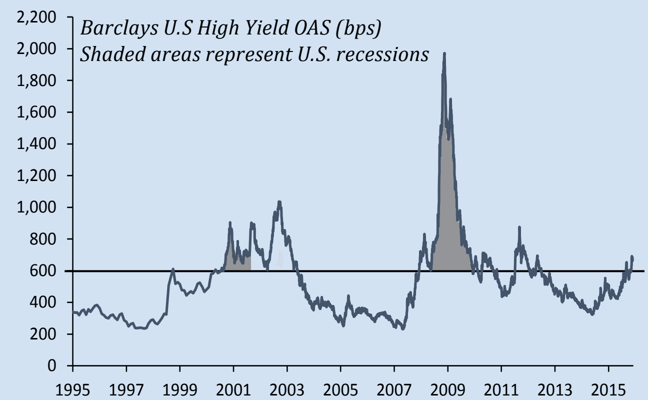
Index	2015 Total Return (%)
Agency MBS	1.51
Intermediate Corporate	1.08
CMBS	0.97
Treasury	0.84
Aggregate	0.55
Bank Loans	-0.38
Corporate	-0.68
S&P 500	-0.70
High Yield	-4.47

Source: Barclays, Credit Suisse, S&P as of December 31, 2015

High Yield is telling us...

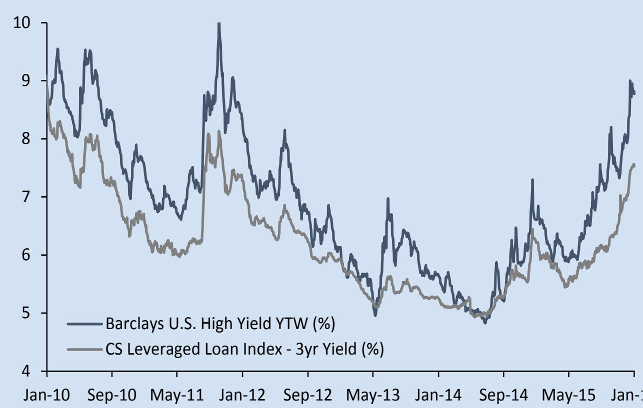
With high yield spreads above 600bps, markets are pricing in a lot of bad news. The question is are spreads indicating a coming recession, or simply overblown fears such as those in 2011.

High yield spreads above 600bps have historically been associated with U.S. recessions



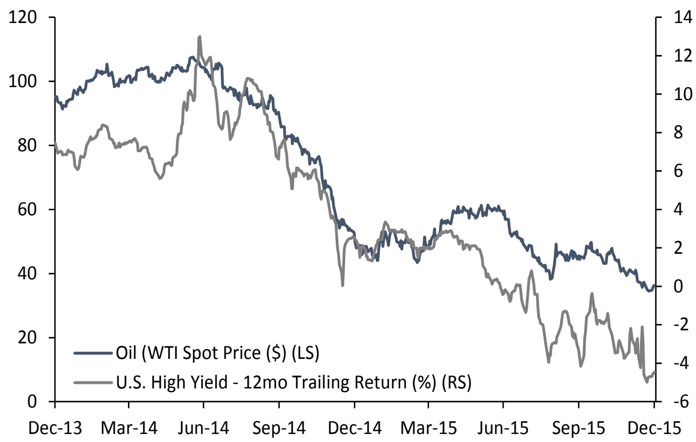
Source: Barclays, as of December 31, 2015

With yields now at 2011 levels, a return of risk appetite could mean credit market outperformance given current valuations



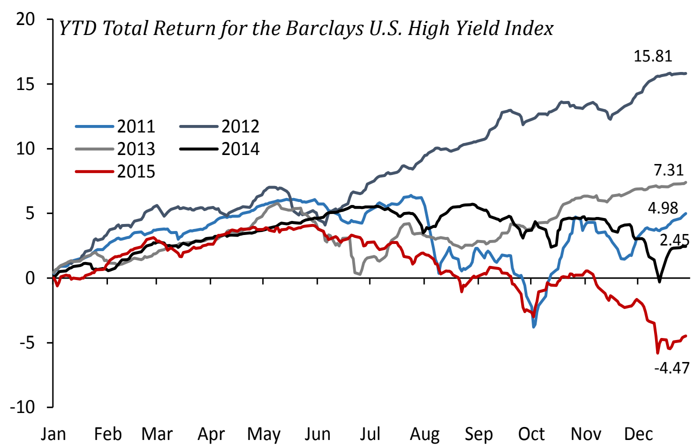
Source: Barclays, Credit Suisse, as of December 31, 2015

Chart 1: High yield posted one of its worst calendar returns in 2015, fueled by a collapse in energy prices (pun intended)



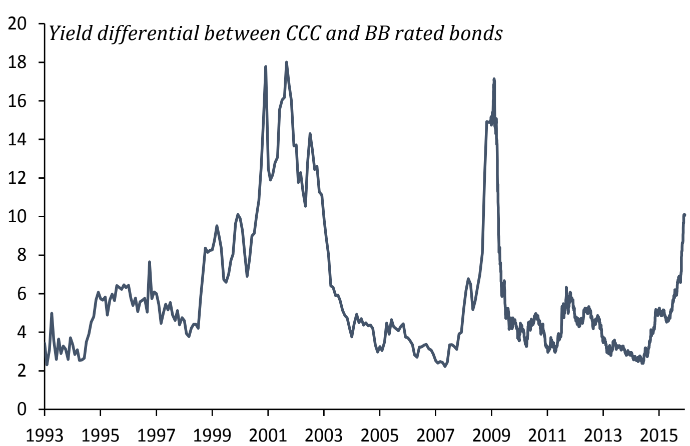
Source: Barclays, St. Louis Federal Reserve, as of December 31, 2015

Chart 2: Once again, the second half of the year proved volatile for high yield, a pattern consistent of the past five years



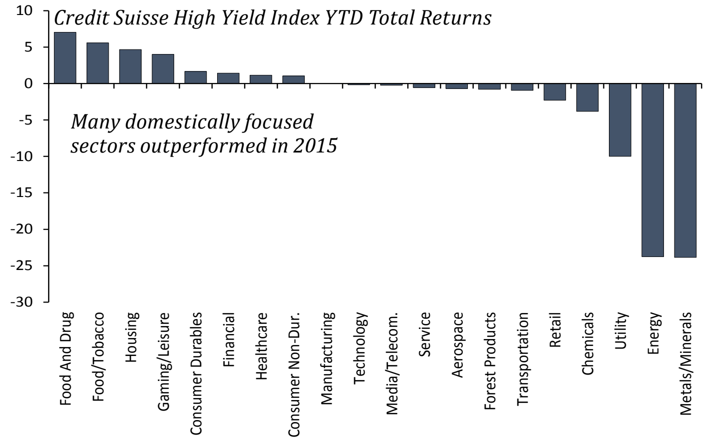
Source: Barclays, as of December 31, 2015

Chart 3: The lack of risk appetite was most evident in the divergence between BB and CCC yields



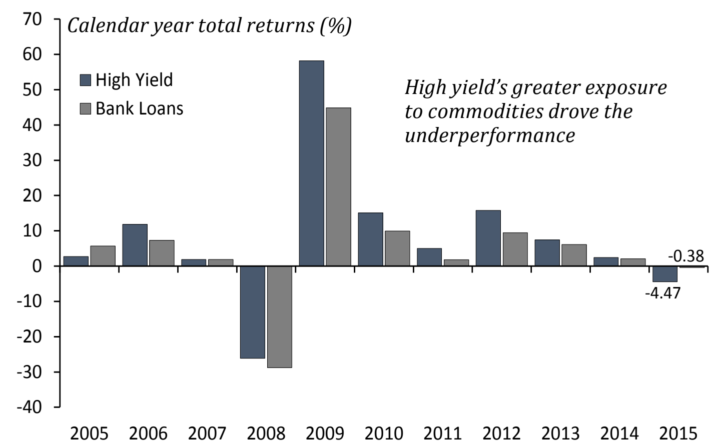
Source: Barclays, as of December 31, 2015

Chart 4: 2015 saw the widest dispersion of sector returns since 2008



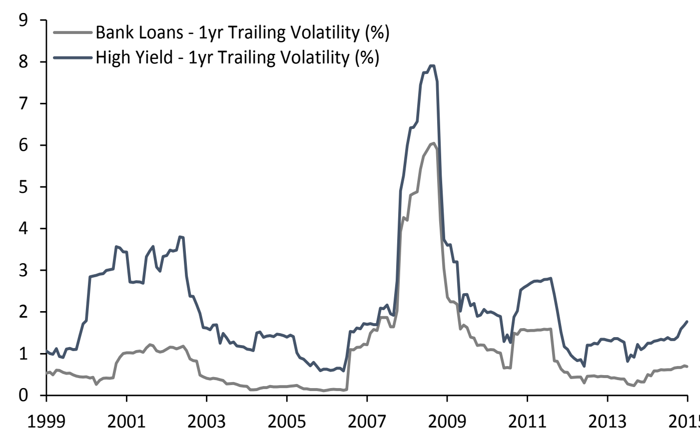
Source: Credit Suisse, as of December 31, 2015

Chart 5: Bank loans outperformed high yield bonds for the first time since 2005...



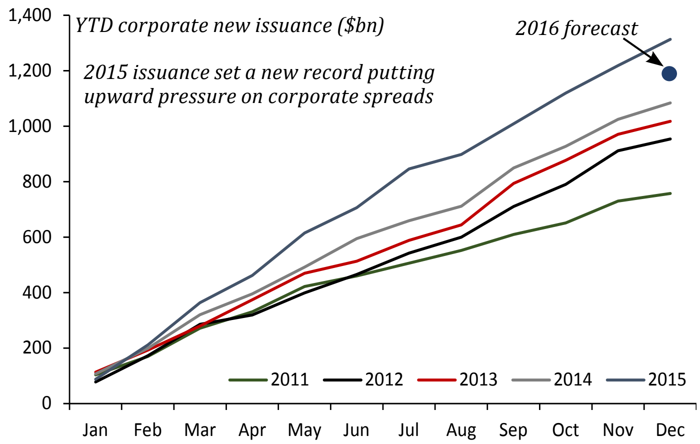
Source: Barclays, Credit Suisse, as of December 31, 2015

Chart 6: ...while continuing to exhibit lower volatility.



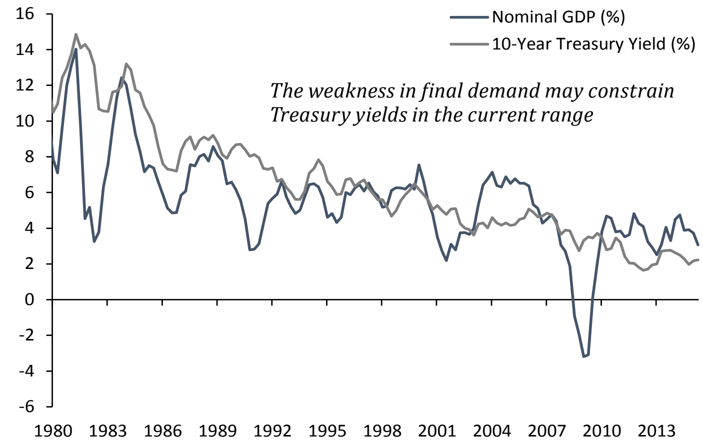
Source: Barclays, Credit Suisse. Shown as 1-year trailing standard deviation of monthly returns. As of December 31, 2015.

Chart 7: M&A activity and stock buybacks resulted in record supply, a negative technical for corporate bonds



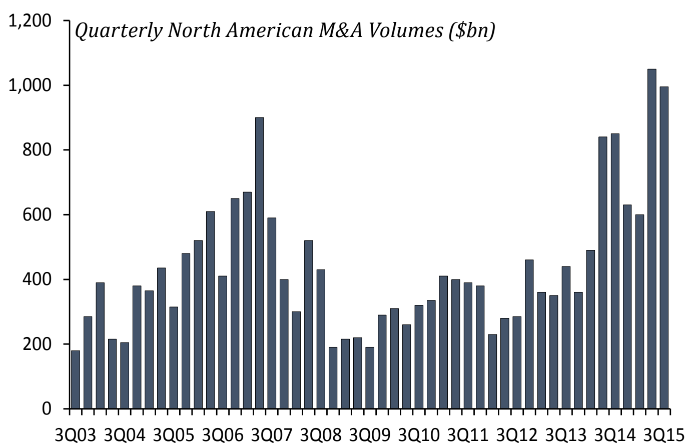
Source: Deutsche Bank, as of December 31, 2015

Chart 10: It's the outlook for growth and inflation, not Fed policy, that drives longer maturity Treasury yields



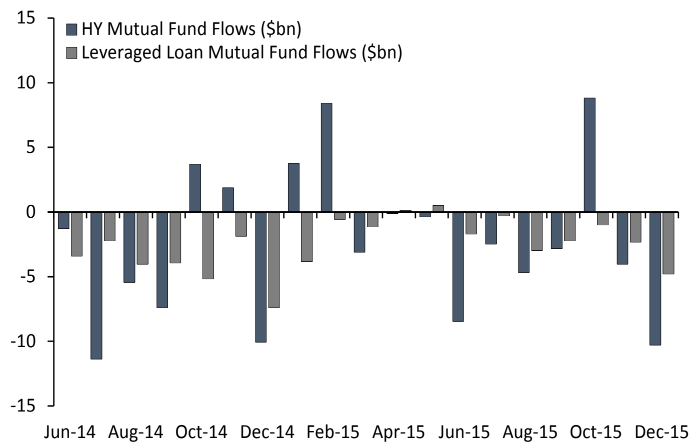
Source: St. Louis Federal Reserve, as of October 1, 2015

Chart 8: Companies are choosing mergers and acquisitions over organic growth. A theme we expect to continue in 2016.



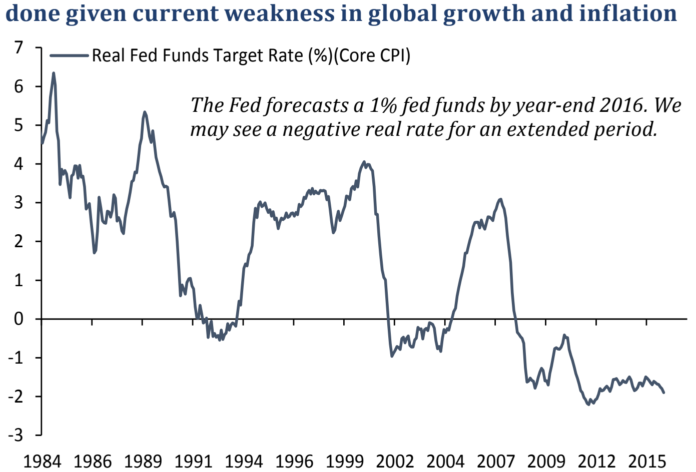
Source: ML/BOA, as of September 30, 2015

Chart 11: Outflows from retail funds exacerbated negative technicals and the poor risk appetite seen in 2015



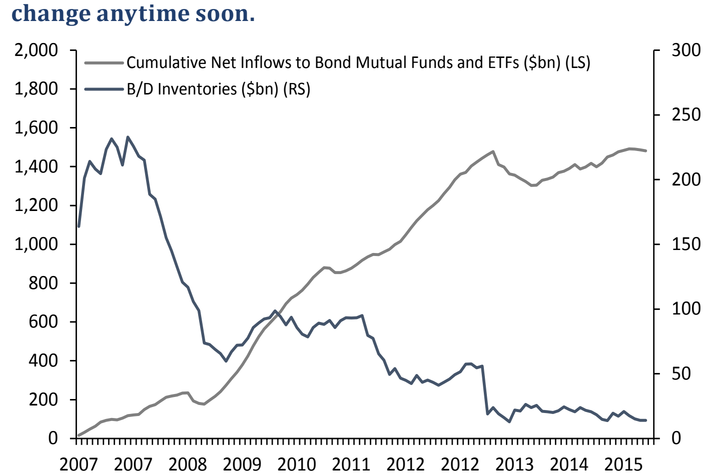
Source: JP Morgan from Lipper fund data, as of December 24th, 2015. December estimated for the week ending the 24th.

Chart 9: Don't fear the Fed, there is not much tightening to be done given current weakness in global growth and inflation



Source: St. Louis Federal Reserve, as of December 31, 2015

Chart 12: Low inventories are the primary culprit behind the poor liquidity environment, a dynamic that is not expected to change anytime soon.



Source: Bloomberg, IMI, as of December 24, 2015

Weak technicals negatively impacted returns in two ways. For corporate bonds, the record setting issuance of more than $1.3trn placed upward pressure on spreads. The record issuance was driven by M&A activity and industry consolidation. Corporate boards and management teams chose to purchase growth rather than grow organically. The second part of the technical picture revolved around volatility in mutual fund flows and lack of dealer liquidity. Record setting outflows from credit funds in late 2015 against a poor liquidity environment exacerbated the impact from selling pressure.

What's in store for 2016?

Growth expectations, weak technicals, commodity prices, and company performance are likely to be an overhang into 2016. Global growth concerns amongst a weak fundamental backdrop means a market environment of higher risk premiums and divergent company performance. Thus, the dispersion of issuer performance in 2015 is likely to continue in 2016.

While the worst performing sectors from a previous year could offer "value" to investors the next, for energy and metals/mining, we advocate caution. The capital destruction in commodity companies and the likely surge in defaults and distressed situations leaves us underweight the sectors entering 2016.

The Federal Reserve began the long awaited move off of ZIRP (Zero Interest Rate Policy) in December. While much ink will be spilled on the Fed's policy intentions, there is limited tightening available given the current outlook for growth and inflation. Higher Treasury yields need higher growth rates, something that continues to escape this economic cycle. We believe Treasury yields will remain range bound in 2016. The aggressive policies from the BOJ and ECB will also put downward pressure on U.S. Treasury yields.

The higher credit spreads and risk premiums today reflect a business cycle in later stages, global growth concerns, and diminished liquidity. We enter 2016 with underweights to OAS (spread) vs. our benchmarks. However, volatility and value are creating opportunities at the issuer level. We believe many issuers now provide yield and spread levels that are attractive entry points and may act in early 2016 on credits we believe to be oversold. This is notably in more domestically focused companies and BB/B loan and bond capital structures.

Summing it up: 2015 saw the first negative returns from credit markets since 2008. Global growth concerns, significant declines in commodity prices, and poor technicals led to the underperformance of credit and wide dispersion of issuer performance. Entering 2016, we appear to be at the late stages of a unique business cycle and credit markets are pricing in quite a bit of bad news. While we remain underweight spread risk versus benchmarks, attractive entry points for many issuers are being created where we believe the pendulum of fear has swung a little too far.

Pacific Asset Management
December 2015

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 September 30, 2015 Pacific Asset Management managed approximately $5.6bn.

FOR MORE INFORMATION

Pacific Asset Management • 700 Newport Center Drive • Newport Beach, CA 92660 • www.pam.pacificlife.com