August 2015
PACIFIC FUNDS
Manager Insight Series

Commentary from Pacific Asset Management, the manager of the Pacific Funds℠ Fixed Income Funds.

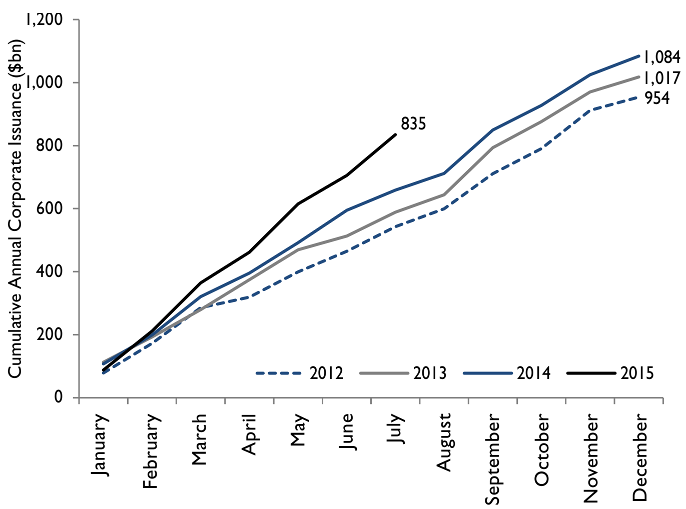
Summer of Supply

The pace of corporate debt issuance is likely to set a new annual record in 2015. Driven by increased Mergers & Acquisition (M&A) activity, record supply is negatively impacting corporate bond performance. In this article, we discuss the record supply, reasons for the supply, and the impact on corporate bonds.

Record Corporate Issuance

Corporate debt issuance in the U.S. is expected to exceed $1.4 trillion in 2015, surpassing the 2014 record of $1.1 trillion (Chart 1). In the first half of 2015, bond issuance in the two largest non-financial sectors, energy and healthcare, increased 55% and 135%, respectively, compared to the first six months of 2014.

Chart 1: Corporate debt issuance is well on track to exceed 2014's record of $1.1 trillion



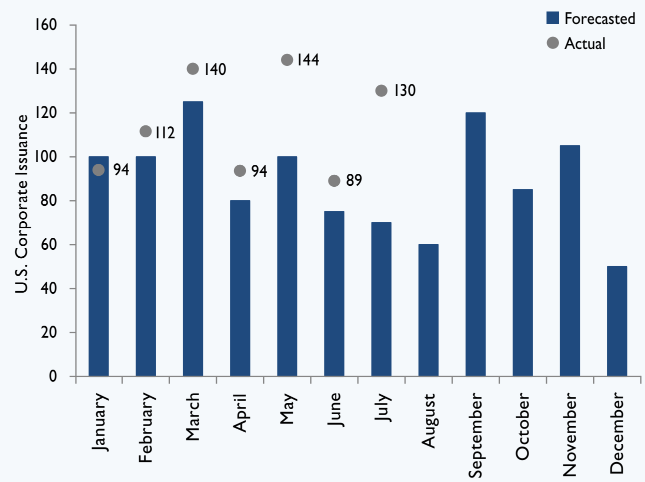
Source: Deutsche Bank, as of July 31, 2015.

Debt issuance by companies in the technology, media, and telecom sectors also increased 37% over the same period. The supply numbers would be even more remarkable if not for the growing trend of U.S. corporations issuing in Europe. U.S. corporate issuance in Europe is estimated to be around $100 billion through June as companies seek to capitalize on lower financing costs.

Supply Surge

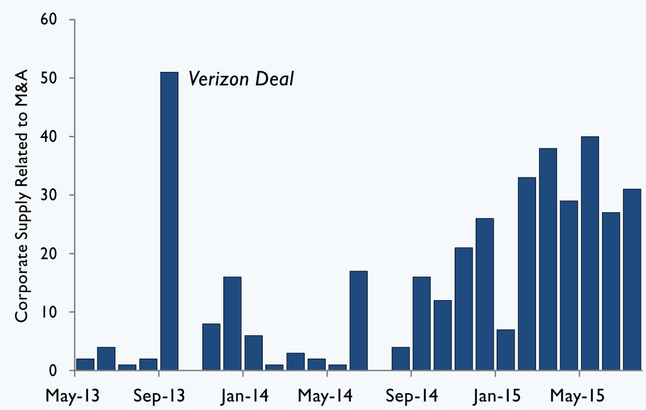
Improving business conditions, open capital markets, and accelerating M&A activity are driving record corporate new issuance in 2015.

Corporate issuance year-to-date has significantly exceeded forecasts, especially during the second quarter



Source: Deutsche Bank, as of July 31, 2015.

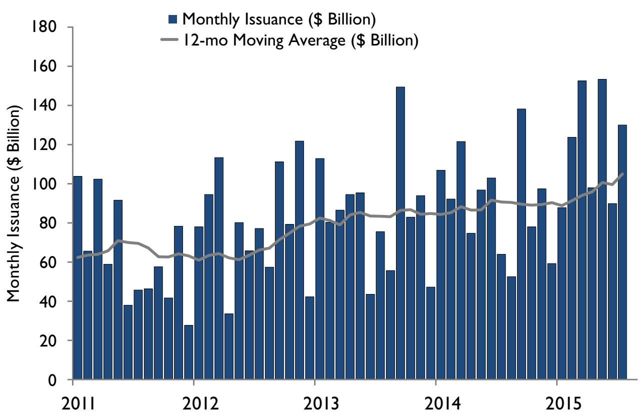
Acquisition-related financing is driving the surge in supply



Source: Merrill Lynch/Bank of America, as of July 24, 2015.

In the U.S., M&A activity has been a major contributor to the record issuance, with acquisition-related financing up $120 billion in 2015 compared to the first six months of 2014. M&A activity has been most prevalent in the healthcare and technology sectors, where M&A new issuance volumes for the first six months of the year are up over 150% and 100%, respectively, versus the first six months of 2014.

Chart 2: Corporate debt issuance is averaging $119 billion per month in 2015



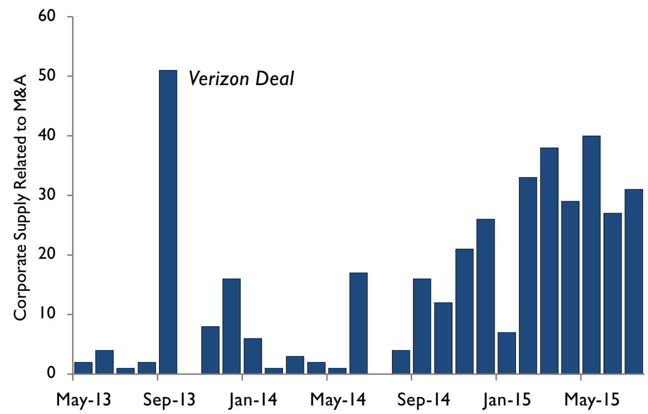
Source: Deutsche Bank, as of July 31, 2015.

Why the Increase in M&A?

The current conditions of this business cycle are fostering an environment for acquisition activity. Low costs of funding, open capital markets, high cash balances, shareholder demands for return on capital, improving business sentiment, and a lack of organic growth opportunities are all driving M&A activity.

Industry consolidation, notably in mature sectors such as technology, healthcare, and media/cable has been a particular hallmark of this surge in M&A. Telecommunications, Media & Technology (TMT) and healthcare M&A volumes comprise nearly half the total M&A activity since the start of 2014, despite the fact that combined, TMT and healthcare companies make up less than a quarter of the Barclays U.S. Corporate Index. Recent deals such as the Intel acquisition of Altera (technology sector), the UnitedHealthcare purchase of Catamaran (healthcare), and the Charter merger with Time Warner Cable (telecom/media) illustrate the industry consolidation-fueled M&A activities. In contrast, the financial sector has been the M&A laggard, accounting for a third of the corporate debt market (as measured by Barclays U.S. Corporate Index), but only account for approximately 15% of the M&A activity since the beginning of 2014.

Chart 3: Acquisition financing is driving the surge in supply



Source: Merrill Lynch/Bank of America as of July 24, 2015.

What Does This Mean for Investors?

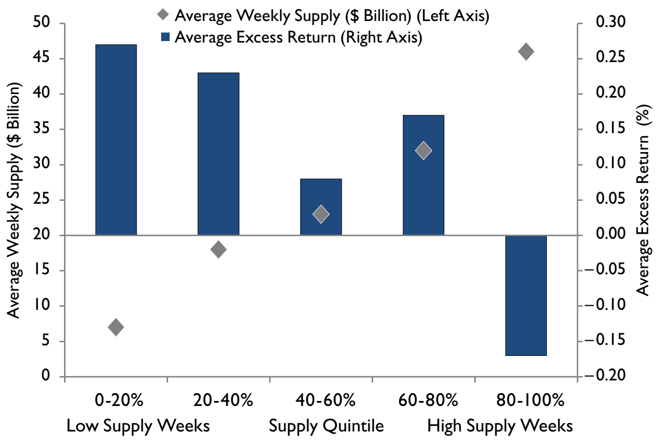
The current technical backdrop has been negatively impacting corporate bond performance (Table 1). First, record supply has negatively impacted spreads on new issuance and secondary market levels. Chart 4 illustrates the weekly impact new issuance typically has on spreads as high supply weeks are correlated with decreasing excess return. Second, inflows have weakened into investment-grade bond mutual funds—in anticipation of higher Treasury yields driven by Federal Reserve policy or in response to the lackluster total returns seen year-to-date. These conditions have led to a poor technical backdrop, contributing to negative excess returns. The impact of these negative technicals has been felt most strongly on longer duration corporate bonds, given a sizeable proportion of new issuance focused on the longer end of the curve.

Table 1: Corporate bonds underperforming on an excess return basis

Index	YTD Total Return	YTD Excess Return
Treasury	0.87	–
Corporate	–0.25	–1.14
Intermediate Corporate	1.08	–0.32
Bank Loans	2.96	N/A
High Yield	1.46	0.32

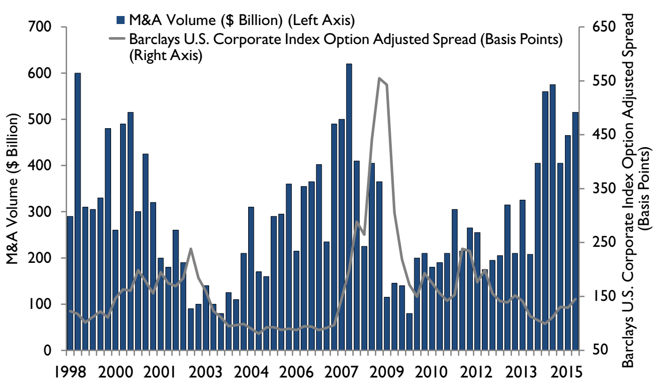
Source: Barclays, Credit Suisse, as of July 31, 2015.

Chart 4: Corporate bond performance has been correlated with new issuance and supply



Source: Barclays, as of June 30, 2015.

Chart 5: M&A activity has historically been most robust during the late stages of economic expansion



Source: Morgan Stanley, as of June 30, 2015.

In the longer term, the acceleration of M&A activity has historically been associated with a maturing credit cycle and negative excess returns for corporate credit. However, today's M&A cycle has been unique, in large part due to current business conditions. A 2% Gross Domestic Product environment, increasing regulatory headwinds, and demand uncertainty are all contributing to a lack or unwillingness to grow business organically. Corporations, under pressure by shareholders for growth and multiple expansion, are actively buying growth within their industries as a response. This is in stark contrast to the aggressively levered deals and capital destructive Leveraged Buy Outs in 2006–2007 that marked the peak of the prior credit cycle.

Outlook—Continued M&A and Mindfulness in a Very Long Cycle

In 2015, sizeable acquisition activity has led to record new issuance, negatively impacting corporate bond performance. This issuance has been fueled by a surge in M&A. In the near term, acquisition-related issuance may see a slowdown as announced deals may not seek to tap the capital markets until late 2015. In our opinion, this should benefit spreads in the short term as the market absorbs less issuance. However, increased M&A is indicative of late-cycle behavior. Factor in a prolonged period of low defaults, a net increase in gross leverage from corporations, and the first rate hike in almost a decade imminent, we need to be mindful of the sustainability of the current credit cycle. Selectivity of issues will continue to be a key factor in driving value-added returns in our fixed-income funds.

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Bank Loans is based on the Credit Suisse Leveraged Loan Index, which is designed to mirror the investable universe of the U.S. dollar denominated leveraged loan market.

Corporate is based on the Barclays U.S. Corporate Index which includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be registered with the Securities and Exchange Commission (SEC).

High-Yield is based on the Barclays U.S. High-Yield Index, which covers the universe of fixed rate, non-investment-grade debt.

Intermediate Corporate is based on the Barclays U.S. Intermediate Corporate Bond Index, which is the intermediate component of the Barclays U.S. Corporate Bond Index. The Barclays U.S. Corporate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

Treasury is based on the Barclays U.S. Treasury Index, which includes public obligations of the U.S. Treasury.

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 (Pacific Life). As of June 30, 2015, Pacific Asset Management managed approximately $5.56 billion. Assets managed by Pacific Asset Management include assets managed at Pacific Life by the investment professionals of Pacific Asset Management.

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Pacific Life Fund Advisors LLC (PLFA), a wholly owned subsidiary of Pacific Life Insurance Company, is the investment advisor to the Pacific Funds. PLFA also does business under the name Pacific Asset Management and manages certain funds under that name.

Effective December 31, 2014, Pacific Life Funds and its family of mutual funds changed its name to Pacific Funds. In addition, individual funds were also renamed. For more information, please visit www.PacificFunds.com.

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Mailing address:
P.O. Box 9768, Providence, RI 02940-9768
(800) 722-2333, Option 2 • www.PacificFunds.com