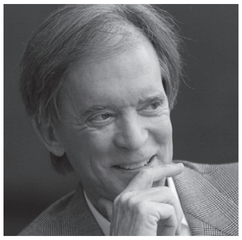
PIMCO

Your Global Investment Authority

Q&A

JUNE 2013

Which way for bonds? Mapping a path forward



Bill Gross
PIMCO Founder and Co-CIO

Q: Can you explain what is happening in markets now?

Gross: In 1980, the Federal Reserve, led by Paul Volcker, tightened the quantitative noose to tame double-digit inflation, fueling an unprecedented tailwind for bond prices. Thirty years later we find ourselves at the other extreme, as central banks print money in the trillions of dollars to stimulate economic growth, and inflation is abnormally low. While we are not likely to see a repeat of that type of bull market any time soon, we also do not believe we are at the beginning of a bear market for bonds. Rather, what we're seeing is the continuation – and acceleration, in some respects – of the de-levering process, a key distinction that may be getting lost in some of the noise over the past few weeks. The Fed, the Bank of England, and now the Bank of Japan have all committed to holding their easing stance until growth targets are hit. We don't see the Fed raising rates in a meaningful way for at least the next few years.

That said, we believe caution is warranted not just for fixed income investors, but for investors in all risk assets. Central banks have reached a critical inflection point in which the negatives of their aggressive policies may be outweighing the positives and in fact hampering growth. Where their monetary repression <u>has</u> succeeded, however, is in forcing investors to take increasing amounts of risk, but for lower yields and more volatile returns.

Q: When do you expect the Fed to begin to take its foot off the QE pedal? Are rising rates a concern?

Gross: The Federal Reserve has cited an unemployment rate of 6.5% as its threshold for pulling back on monetary policy. At the same time, Chairman Bernanke wants to avoid the mistake of premature tightening, as occurred disastrously in the 1930s. While we agree with this reasoning, we are concerned by the growing downside of zero-based money and QE policies – among them a worrisome distortion in asset pricing, the misallocation of capital and ultimately a dis-incentivizing of risk taking by corporations and investors. The Fed shares these concerns as well, which is why some members are considering a reduction or tapering of purchases. From a technical perspective, the Fed may also be forced to taper its purchases to match the shrinking U.S. budget deficit. But there's a difference between a mild reduction and a decision by the Fed to materially scale back its bond purchase program. The economy has yet to achieve escape velocity, and unemployment is still stubbornly high and structural in nature. So while we may see some tapering, possibly by the end of the year, we do not expect the Fed to remove the trough for some time or for this to signal a dramatic increase in rates. Rates will fluctuate over the shorter term, of course, and it's our job as active managers to effectively position our clients' portfolio if that occurs. This is something we have done for our investors for decades.

Q: How are you positioning Total Return to navigate this environment?

Gross: While it's natural to want to reach for higher returns, an investment strategy's success depends on carefully weighing potential rewards against the long-term costs, using the insights you've gathered on the ground and on a macro level through rigorous analysis. Today, given the economic uncertainty and rich market valuations, we think that the fortitude to wait for more attractive opportunities is a valuable attribute. Our goal for the Total Return strategy is to enhance our dry powder, seek prudent alpha and reduce risk – not dramatically, but to average or slightly below-average levels. Fortunately, PIMCO has a wide array of tools at our disposal to accomplish that. So, among other things, we're avoiding long durations, reducing credit risk away from economically vulnerable companies and sectors, managing volatility and increasing exposure to countries with higher-quality balance sheets such as the U.S., Brazil, Mexico and Australia. And we are seeking out and taking advantage of opportunities in the market. For example, we believe intermediate Treasuries are currently attractively priced at around 2%.

At the forefront, PIMCO's first and most important objective is preserving our clients' capital, as it has been since Total Return was launched more than a quarter-century ago. In a market environment such as the one we're currently navigating, this risk management priority becomes even more essential. In the meantime, we believe our portfolios are well positioned for future opportunities. If "traditional" bond beta is likely to be subdued, as we are forecasting, there are still ways for a resourceful and experienced investment manager to generate alpha from less traditional sectors.

Q: With bond markets so uncertain, what steps can investors take to ensure they're prudently pursuing their financial goals?

Gross: It's important for investors to remember the reasons they own bonds in the first place – namely for the potential for the preservation of capital, income and growth, relative steadiness and typically low to negative correlations with equities. These needs – which will only become more urgent as millions of baby boomers head to retirement over the next decade and a half – are long term, regardless of what markets are doing today. So fixed income should always have a place in a portfolio. Still, there are ways to navigate challenging markets without feeling stuck. One is to expand your investment universe by going global. Here at PIMCO we like to say that there is no "bond market," but rather "a market of bonds." So, you should prize flexibility in your fixed income manager or core bond strategy.

Finally, be patient. Times are challenging, to be sure, but PIMCO has been successfully investing through more than four decades of market and economic cycles, which gives us some perspective, as well as the confidence that we're going to be around to fight for the next 40 years. We certainly hope our clients take some comfort in that.

13-0825-GBL

Newport Beach Headquarters
840 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

Amsterdam

Hong Kong

London

Milan

Munich

New York

Rio de Janeiro

Singapore

Sydney

Tokyo

Toronto

Zurich

pimco.com

PIMCO