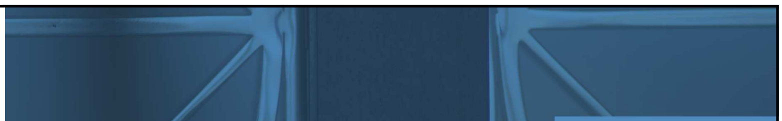
PIMCO

Your Global Investment Authority



INSIDEPIMCO

Credit Perspectives – How Tight Is Too Tight?

CFA Toronto Annual Forecast Dinner

Christian Stracke | October 2014

Fund Manager of the Year
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2012

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Key Forecasts – Expect More of the Same

1. Credit spreads should be broadly unchanged over the next year
   - IG spreads to stay around +120bp (roughly 3.25% yields)
2. High Yield and Europe more exposed than IG
   - China will remain a real drag on HY & Europe in particular
3. Tim Hortons probably isn't the last Canada tax inversion we'll see

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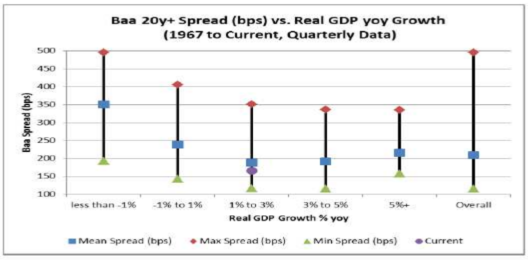
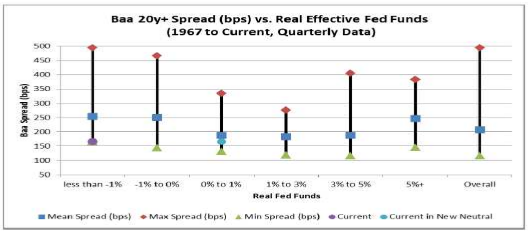
"New Neutral" and Credit Valuations

PIMCO's New Neutral outlook – real neutral policy rates significantly lower than in the past – should continue to support credit markets

Low real policy rates and low but steady economic growth help support credit markets by dampening volatility

Even if the Fed does begin to bring rates higher, risk-free rates will remain extremely low and will continue to drive investors into risk assets, including credit





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U.S. IG – Fundamentals Are OK, Not Excellent…

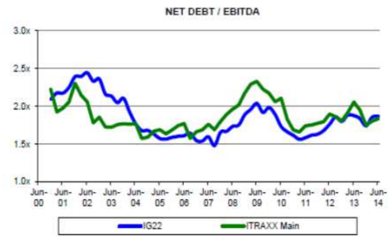
US IG companies have seen moderate revenues growth of ~2.5% year over year

- Media, Healthcare, Cable, have seen revenue growth of 5-8% and EBITDA growth of 6-13% year over year.
- Weakness seen in metals and mining and construction.

U.S. Capex guidance more positive on average

Average net leverage remains stable at below 2.0, although we would prefer to see leverage declining with companies near peak EBITDA levels

Source: CapitalIQ



Source: CapitalIQ

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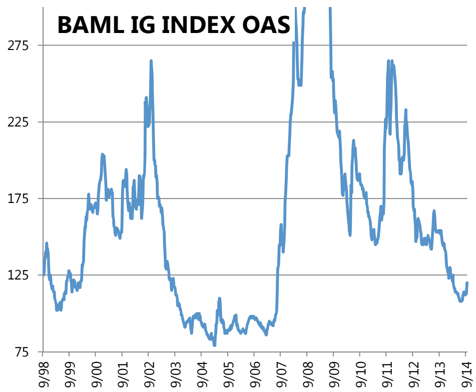
…But Valuations Are Not Particularly Stretched Given No Recession in Sight

IG Spreads are still about 25bp above where they stood from late-2003 through mid-2007

At current spreads, we see credit priced essentially fair – fundamentals are solid if not excellent, policy remains supportive, and valuations are not especially stretched, especially when compared to equities and other risks assets

One key differentiator today is the banks – After Basel III the systemically important banks are far better credits less prone to liquidity accidents than they have been in decades



Source: BAML Indices

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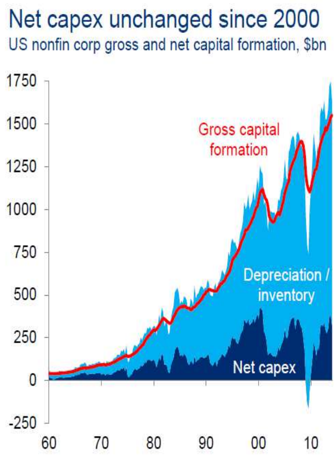
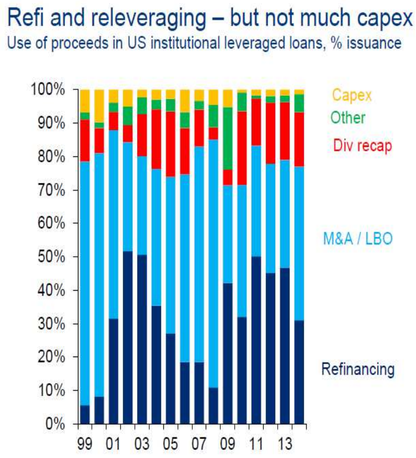
CAPEX – When Will It Kick into High Gear?



Source: Federal Reserve.



Source: S&P LCD.

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European IG Fundamentals – The China Drag (and the Russia Drag…)

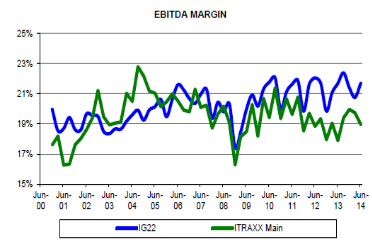
Europe lags behind the US in the credit cycle.

Top line revenue growth of 0.3%

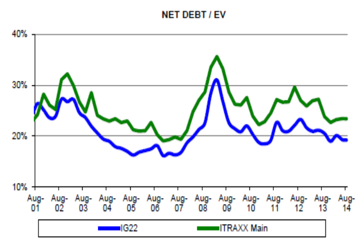
- Autos, Energy, Basics EBITDA increased by 9-17% year over year.
- Utilities, Capital Goods, Healthcare EBITDA declined 4-6% year over year.

European Capex likely to decline, with weakness in Mining and Steel, Chemicals, Aerospace/Defense, Oil and gas.

European margins have declined relatively, but market value of assets continue to rise faster than net debt.



Source: CapitalIQ



Source: CapitalIQ

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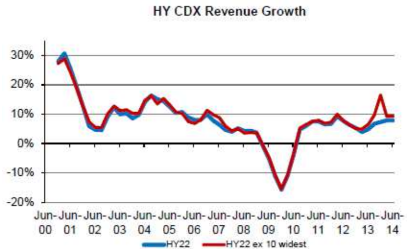
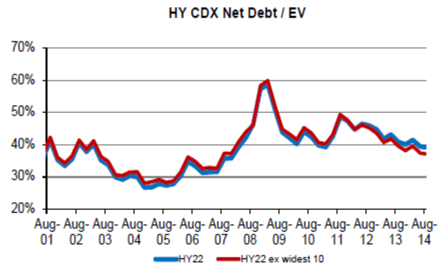
High Yield – Fundamentals Have Improved, But Not as Much as We'd Like to See

High yield earnings and growth have been improving and remaining year guidance from company management remains constructive.

While leverage at HY companies has been slowly trending down as EBITDA has increased, leverage is still significantly above 2004-06 levels, a sign that HY companies are more willing to use aggressive balance sheet management

Pockets of real trouble persist in HY: metals and mining, retail, apparel.





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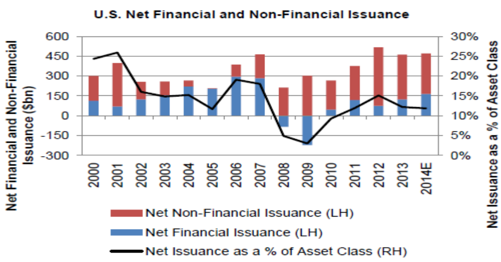
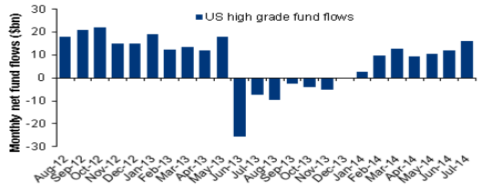
Technicals in Global Credit

- Technicals in the US are neutral:
  - US expected net positive supply for 2014 of $470bn, about 12% of the asset class
  - This compares to 4.6% coupon paid and 4.5% retail inflow YTD
- Technicals in Europe are supportive
  - Expect zero net supply in 2014, as financials pay down senior unsecured
  - ECB actions will drive demand
- Institutional inflow has slowed as the pension funding gap has widened (from 91% to 85%)



Source: JPMorgan, Barclays



Source: BofA Merrill Lynch, EPFR Global

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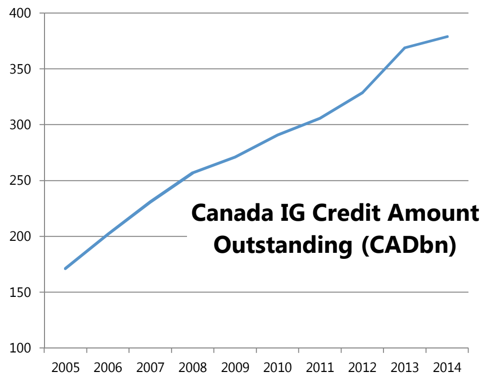
Canada Credit – CAD Denominated Corporate Debt Growth Is Slowing as US Names Exit

The par outstanding CAD-denominated IG corporate debt slowed in 2014, as US issuers, especially banks, are less opportunistic in CAD markets

Since 2006, the share of the CAD IG index represented by Canadian issuers has grown from 81.6% to 85.7%

Over time, expect the CAD IG market to continue its steady growth, and to grow even more Canadian as non-Canada issuers prefer to stick to their home currency



Source: BAML Indices

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Canada Credit – More Tax Inversions to Come?

1. Don't believe the talking points – Burger King/Tim Hortons was at least in part about tax inversion
2. Tim Hortons combined federal + provincial rate is 27.5%, well below the 35% US rate
3. Why is Canada attractive for tax inversion?
   a. It's not Ireland, looks less like a pure tax arb play
   b. A mid-20% tax rate may not be rock-bottom, but it is still attractive vs US

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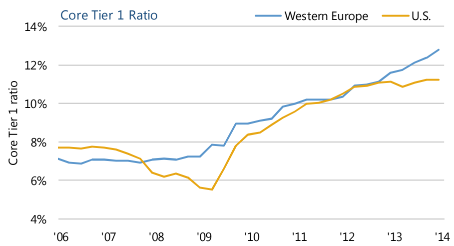
SECTOR PERSPECTIVES

Banks – Supportive Fundamentals & Relative Value in the Capital Structure

▪Investment thesis

- Valuations on most assets are increasing, supported by employment gains and central bank policy
- Regulators require higher equity capital and lower leverage to reduce the risk of bank failures in the future
- Banks have nearly twice the equity capital compared to pre-crisis levels
- Lending activity is picking up, delinquencies are falling and a relatively steep yield curve can all be supportive of bank profitability
- Senior bank spreads are nearly 1.5x their pre-crisis levels, while subordinated spreads are nearly 2x pre-crisis levels



Summary of bank spreads (OAS)

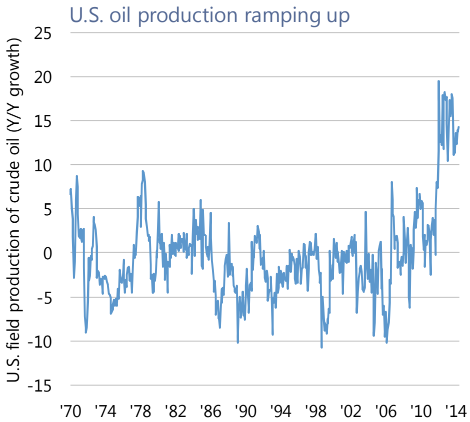
	U.S. Big 6	U.S. special situations	U.K.	Core Europe	Spain / Italy	Japan / Australia	Brazil	Russia
Senior secured	+10	+150	+10 to +60	0 to +20	+50 to +120	0 to +35		
Senior unsecured	+70 to +120	+150 to +250	+50 to +90	+25 to +70	+85 to +150	+85	+200 to +325	+200 to +275
Sub debt / LT2	+140 to +160		+130 to +250	+120 to +250	+250 to +350	+100 to +150	+300 to +370	+330
T1 / CoCos	+250 to +300		+250 to +400	+230 to +375	+350 to +575	+150 to +200	+400 to +550	+450
Equity	P/B 1.3x, P/E 10.8x	P/B 1.1x, P/E 12.0x	P/B 1.3x, P/E 10.2x	P/B 1.0x, P/E 11.7x	P/B 1.0x, P/E 12.5x	P/B 0.9x, P/E 9.7x	P/B 1.5x, P/E 8x	P/B 1x, P/E 6x

Attractive relative valuation | Fair relative valuation | Rich relative valuation

Top Chart: As of 31 March 2014. SOURCE: Morgan Stanley, PIMCO
Bottom Chart: As of 31 May 2014. SOURCE: PIMCO,
Refer to Appendix for additional outlook, OAS and index information.

U.S. Energy – Game Changer in U.S.

- Investment thesis
  - Growth and strong asset coverage
  - Volumes benefiting from emerging U.S. energy/ shale growth
  - MLPs/pipelines have dominant asset footprints
  - Strong equity sponsorship and solid financial flexibility
  - EV/EBITDA pipeline multiples up from 9x in last recession to 15x now



As of 31 May 2014
SOURCE: Energy Information Administration
Refer to Appendix for additional investment strategy, outlook and risk information.

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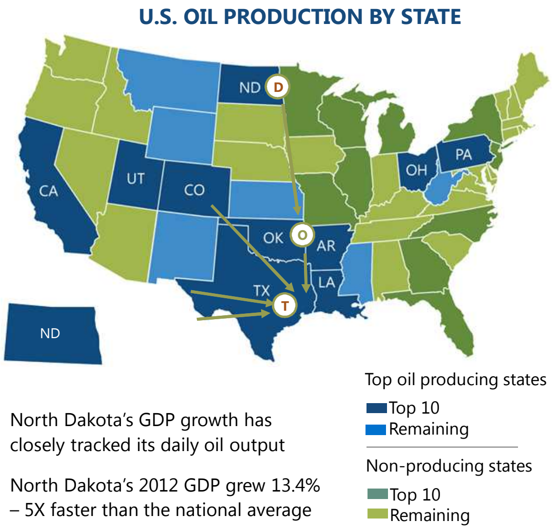
U.S. Energy – Micro Influences Macro

- Investment thesis
  - Oil production, especially in the mid-continent, is boosting state-specific GDP growth
  - Of particular interest are the "DOTs" – North Dakota, Oklahoma and Texas
  - Increased volumes from emerging U.S. energy/ shale growth are benefitting E&P and Pipeline firms



- North Dakota's GDP growth has closely tracked its daily oil output
- North Dakota's 2012 GDP grew 13.4% – 5X faster than the national average

As of August 2013. SOURCE: IHS report
For illustrative purposes only
Refer to Appendix for additional investment strategy, outlook and risk information.

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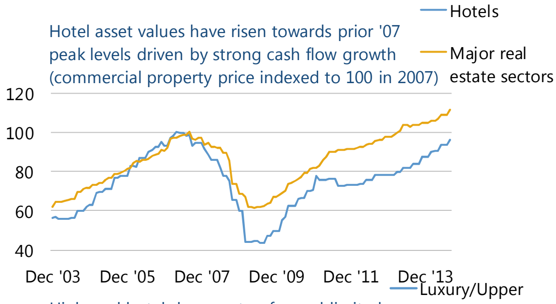
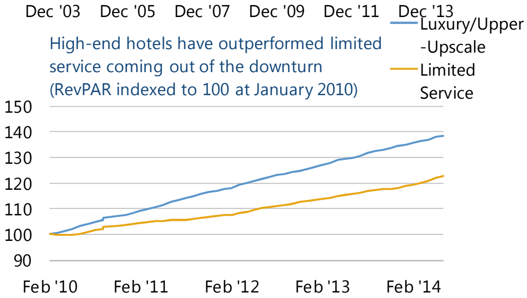
Lodging

- Investment thesis
  - Record-high occupancy levels support continued rate growth; higher rates provides higher EBITDA flow-through
  - Higher-end of the market (luxury and upper-upscale) provides better long-term growth, significant barriers to entry, and pricing power given lower supply risk and fewer competitors
  - Record-high corporate profits drives business demand, while higher home prices and stock markets have boosted confidence and leisure demand





SOURCE: Green Street Advisors (top chart); Smith Travel Research (bottom chart)

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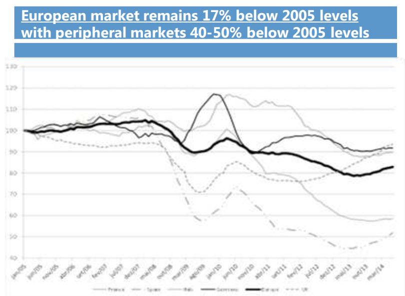
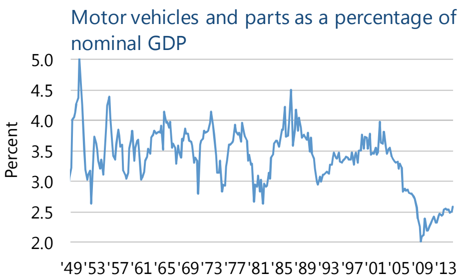
Global Autos – Pent-up Demand and Easier Credit Availability Positive for Autos

- Investment thesis
  - An aging fleet of cars and growing need to trade-in less fuel efficient vehicles suggests there is pent-up demand
  - Easier credit availability should further support new car purchases
  - Improving building and remodeling activity bodes well for full-size truck demand





Top chart as of 30 June 2013, most recent data available
Bottom chart as of 30 June 2014
SOURCE: Haver Analytics
Refer to Appendix for additional outlook and risk information.

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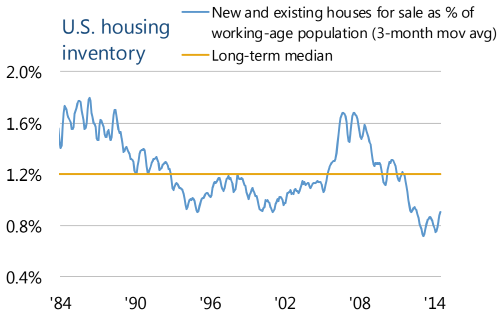
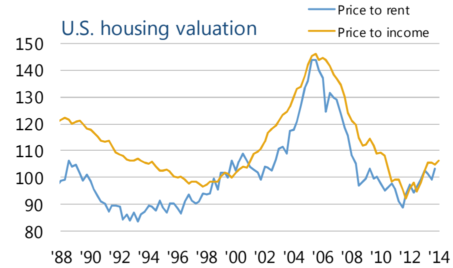
Housing – Favorable Supply/Demand Dynamics

- Investment thesis
  - Housing prices have further upside given supply/demand
  - Buyer psychology is improving with outlook for employment
  - Central banks "all in" with unprecedented monetary policy action
  - Valuations remain attractive





Top chart as of 31 July 2014
Bottom chart as of 30 June 2014
SOURCE: U.S. Census Bureau, National Association of Realtors, Bureau of Labor Statistics, Bureau of Economic Analysis Haver, Bloomberg
Refer to Appendix for additional outlook and risk information.

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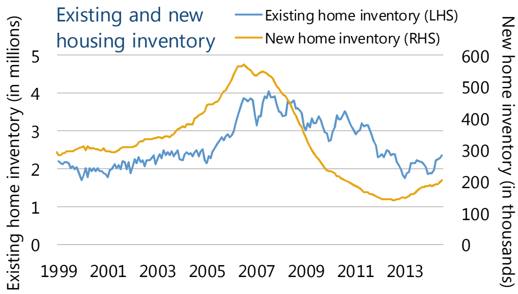
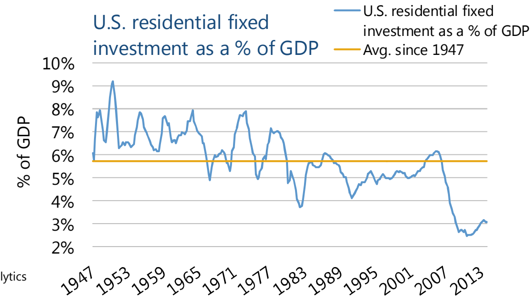
New Construction Has Significant Upside Given Improving Demand

- Investment thesis
  - Home inventories are declining and are near 13-year lows
  - Housing formation and improving access to credit suggest pent-up demand
  - Limited supply in areas with strong job creation
  - Pent-up demand for new construction





Top chart as of 31 July 2014
Bottom chart as of 31 March 2014
SOURCE: National Association of Realtors, U.S. Census Bureau, Haver Analytics
Refer to Appendix for additional outlook and risk information.

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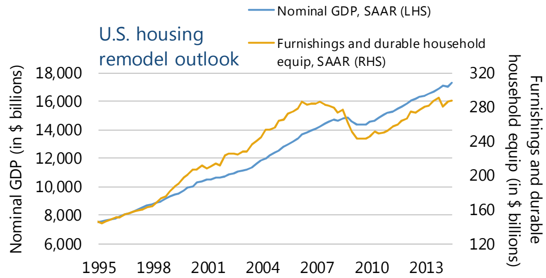
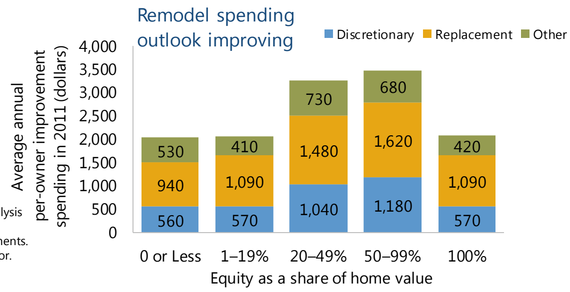
Building Materials – Remodel Spending Picking Up on Improving Home Equity

- Investment thesis
  - Remodel spending tends to improve as home prices increase
  - There are also signs of pent-up replacement demand for normal wear and tear (e.g., new appliances, carpeting, fresh paint)





Top chart as of 30 June 2014
Bottom chart as of 30 June 2011, most recent data available
SOURCE: JCHS tabulations of 2011 AHS; Bureau of Economic Analysis
Discretionary projects include kitchen and bath remodeling, room additions, other major interior improvements and outside attachments.
Replacements include systems and equipment, exterior and interior.
Other includes disaster repairs and other property improvements.
Refer to Appendix for additional outlook and risk information.

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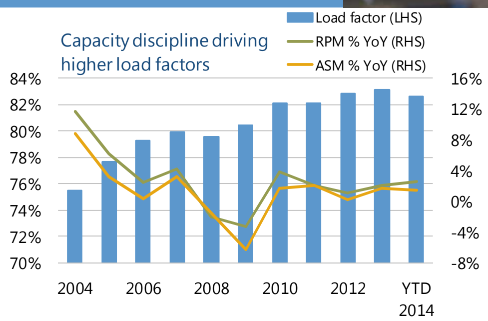
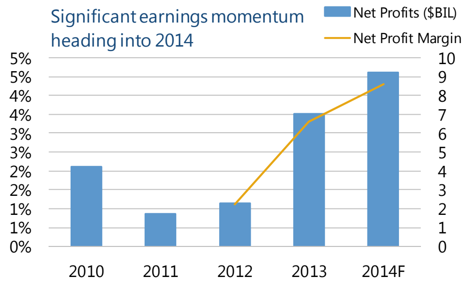
Airlines – industry consolidation driving capacity discipline and higher profitability

- Investment thesis
  - Following the American/US Air merger, the top four U.S. carriers now account for ~90% of the domestic market (vs. 60% in 2005)
  - Aggressive price wars have been replaced by capacity discipline, which is driving higher load factors and better pricing power
  - Mid-single digit passenger growth, combined with the use of more fuel efficient aircraft, to drive earnings momentum in 2014





Top chart as of 31 August 2014
Bottom chart as of 31 March 2014 with 2013 and 2014 estimates from IATA's updated airline outlook (released on March 2014)
SOURCE: Bureau of Transportation Statistics, IATA
Refer to Appendix for additional outlook and risk information.

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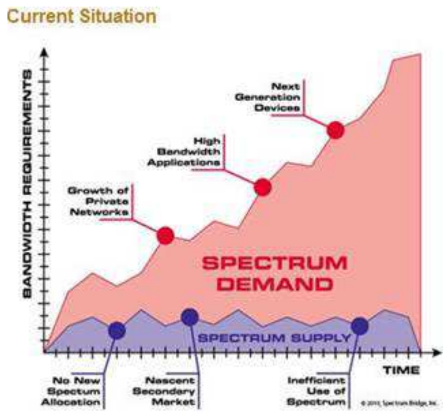
Wireless/Cell Towers – Steady Cash Flows, Solid Credits

- Investment thesis
  - Secular growth in the demand for mobile data communications is expected to continue over the foreseeable future, providing a tailwind for wireless carriers
  - The U.S. wireless industry is consolidated to 4 major players which control the majority of the licensed wireless spectrum available
  - The FCC will auction new wireless spectrum licenses over the next two years, but the incumbent operators are likely to dominate the auction and the total supply of new licensed spectrum will likely be exceeded by the growth in demand
  - Wireless towers are a secondary beneficiary of the growth in mobile data demand as zoning laws and limited availability of premium real estate restrict the number of new supply that can enter the market



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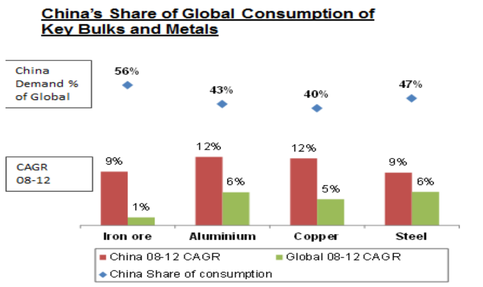
What to Avoid – China-Related Cyclicals

Most indicators show China slowing.

China's is very relevant for select metals.



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China and Metal Outlook

Changing growth dynamics in China lead to higher demand variability.

Concerns on future steel demand from the Chinese property sector undermine market sentiment.

Higher supply from Australia and Brazil are also negative for prices.

China Port Inventories of Iron Ore vs. Iron Ore Price (rebased)

Appendix

Past performance is not a guarantee or a reliable indicator of future results.

CREDIT QUALITY
The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

FORECAST
Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. There is no guarantee that results will be achieved.

INVESTMENT STRATEGY
There is no guarantee that these investment strategies will work under all market conditions and each investor should evaluate their ability to invest for a long-term especially during periods of downturn in the market. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown.

OUTLOOK
Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.

RISK
Absolute return portfolios may not fully participate in strong positive market rallies. Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed**. High-yield**, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Investing in **foreign denominated and/or domiciled securitie**s may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets**. Equities** may decline in value due to both real and perceived general market, economic, and industry conditions. Convertible securities may be called before intended, which may have an adverse effect on investment objectives. **Sovereign securities** are generally backed by the issuing government, obligations of U.S. Government agencies and authorities are supported by varying degrees but are generally not backed by the full faith of the U.S. Government; portfolios that invest in such securities are not guaranteed and will fluctuate in value. Income from **municipal bonds** may be subject to state and local taxes and at times the alternative minimum tax. **Derivatives** may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. Diversification does not ensure against loss.

Appendix

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INDEX DESCRIPTION
The 3-Month LIBOR (London Interbank Offered Rate) Index is an average interest rate, determined by the British Bankers Association, that banks charge one another for the use of short-term money (3 months) in England's Eurodollar market.

The Barclays U.S. Credit Index is comprised of the U.S. Corporate Index and the non-native currency U.S. Government-Related Index. It is a subset of the U.S. Government/Credit index and the U.S. Aggregate Credit Index that consists of publicly issued U.S. corporate, non-U.S. corporate, and specific foreign debentures and secured notes. The index was formerly known as the U.S. Corporate Investment Grade Index and the name change was effective as of 1 June 2000 (statistics) and 1 July 2000 (returns).

Barclays Global Credit Hedged USD contains investment grade and high yield credit securities from the Multiverse represented in U.S. Dollars on a hedged basis, (Multiverse is the merger of two groups: the Global Aggregate and the Global High Yield).

It is not possible to invest directly in an unmanaged index.