

PIMCO

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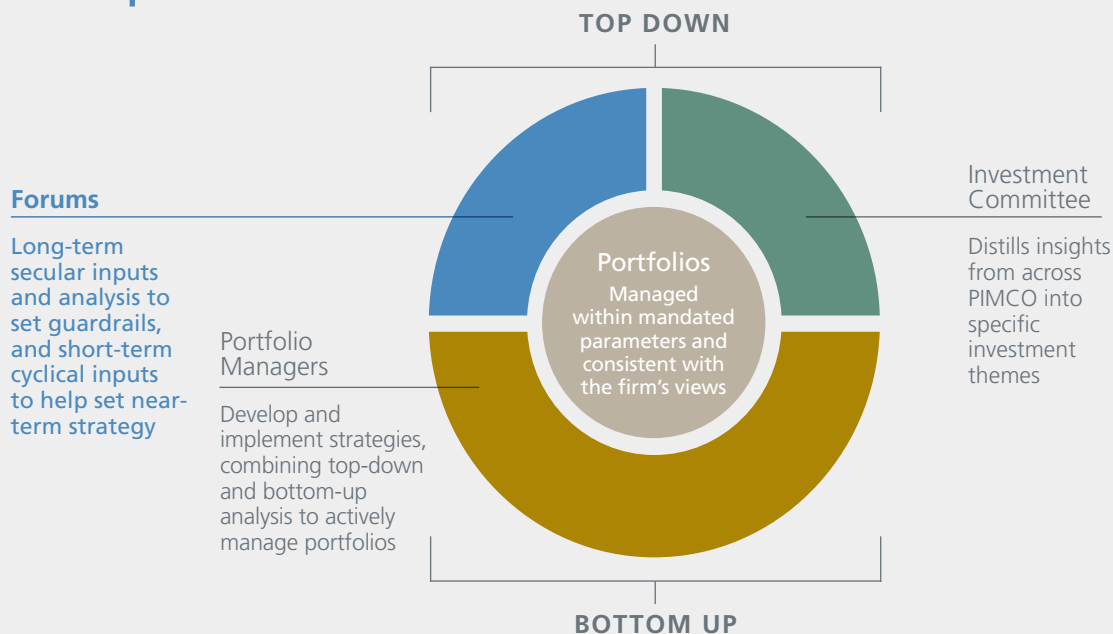
PUTTING MARKETS IN
perspective

PIMCO's Cyclical Forums: Reading the road

PIMCO's economic forums help provide a framework for how we position our clients' portfolios. Our annual Secular Forum looks over a three-to-five-year horizon. Three times a year we also hold Cyclical Forums to test and refine our macroeconomic thinking against current facts on the ground, reconciling likely events in the next six to 12 months with our longer-term forecast.

These cyclical "check-ins" are key to our process, as seen below. If our secular outlook tells us which direction the freeway is headed, then our cyclical outlook reads more immediate conditions so we know which lane to drive in, how fast to go and what the drivers around us are doing.

Our process



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“PIMCO’s outlook for the year ahead is cautiously optimistic, but investors must be alert to both unexpected setbacks and opportunities.”

– Saumil Parikh
Managing Director
Cyclical Forum Leader

While it is often true that slow and steady win the race, there are times when a strong boost is needed just to stay on course. Such appears to be the case with the global economy, which, despite the best efforts of central banks, has been unable to achieve the “escape velocity” needed to secure a path to sustained growth.

This is not to say that no improvements have been made. Indeed, PIMCO’s outlook for the year ahead is cautiously optimistic. The world’s economic giants are all expected to expand, including Europe and China, which had been contracting. However, persistent headwinds make it difficult to predict when or how the necessary handoff to self-sustaining growth will be realized. Hanging in the balance is the outlook for corporate profits, job creation and global economic well-being. The complex interplay of forces means investors must be alert to both unexpected setbacks and opportunities. Nimble, on-the-ground intelligence is essential.

Putting Markets in Perspective is designed to provide some direction. It presents, in a concise format, PIMCO’s latest thinking on key themes fresh from our Cyclical Forums, practical applications for investors and specific solutions to consider.

For more detailed information on our cyclical outlook, as well as additional *Putting Markets in Perspective* resources, visit global.pimco.com/puttingmarketsinperspective.

The global economy just experienced its slowest growth in recent history, but PIMCO's outlook for the year ahead is cautiously optimistic.

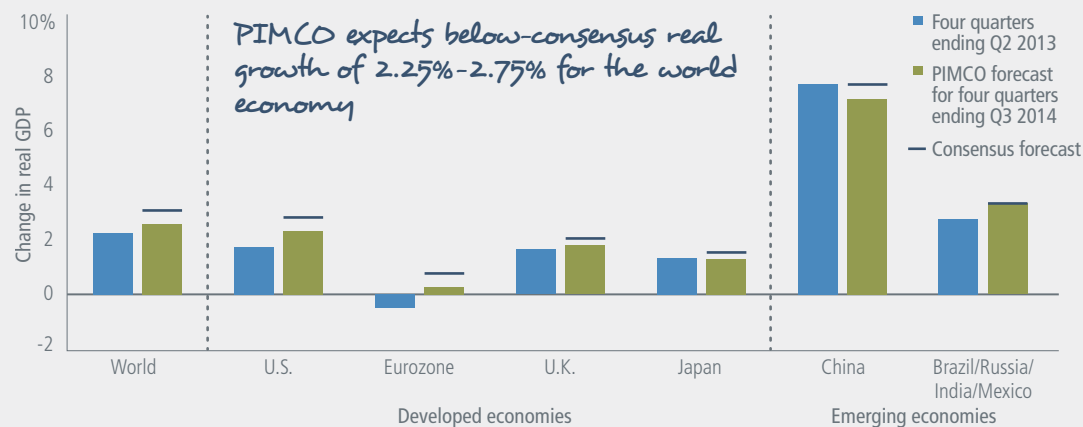
What these charts show

Real global GDP (nominal GDP less inflation) grew just 2.2% for the year ending June 30, 2013. While U.S. and Japanese growth were lower last year, the significant drag came from Europe and the major emerging market countries. Despite the challenging year for growth, PIMCO has upgraded its forecast for the year ahead (first chart). This change was primarily influenced by three trends. First, we believe fiscal policy in the U.S. and Europe will likely be less of a drag on global growth next year. Second, the increase in global financial wealth should strengthen private sector confidence and spending. And third, global central banks will likely continue to use monetary policy to prevent crises. This last point is supported by contained inflation, as seen in the second chart. At these levels, central banks will not be under pressure to raise rates any time soon.

Investment implications

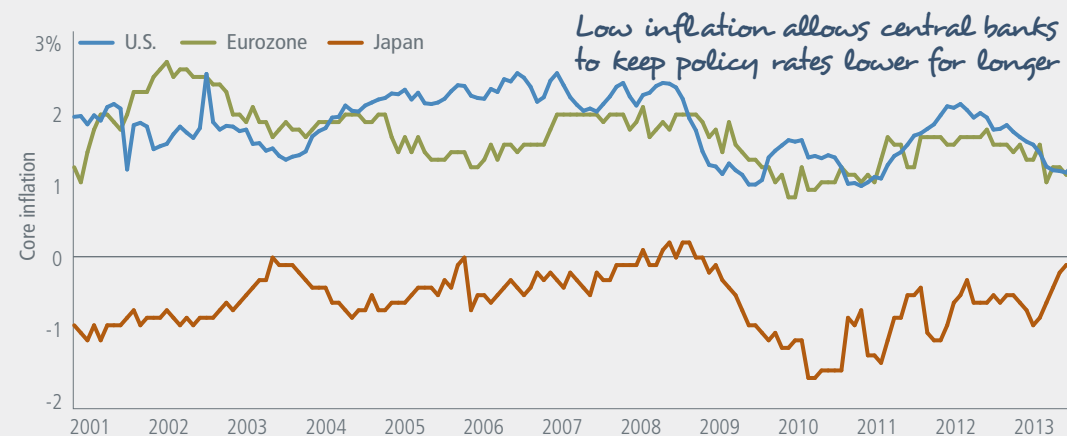
PIMCO's upgraded forecasts are still below consensus expectations. This caution reflects the persistent headwinds facing specific countries and the global economy overall. Rely on active managers with extensive research capabilities to navigate global portfolios in this fluid and challenging environment.

Cyclical forecast: Upgraded but below consensus



Source: Bloomberg, PIMCO. Current data for real GDP represents four quarters ending Q2 2013. World is a weighted average sum of countries listed in the chart.

Inflation remains contained, taking pressure off central banks



Source: Bloomberg. Data through 30 September 2013.

PIMCO expects U.S. growth to pick up, but to disappoint elevated consensus expectations due to rising market interest rates and weak aggregate spending.

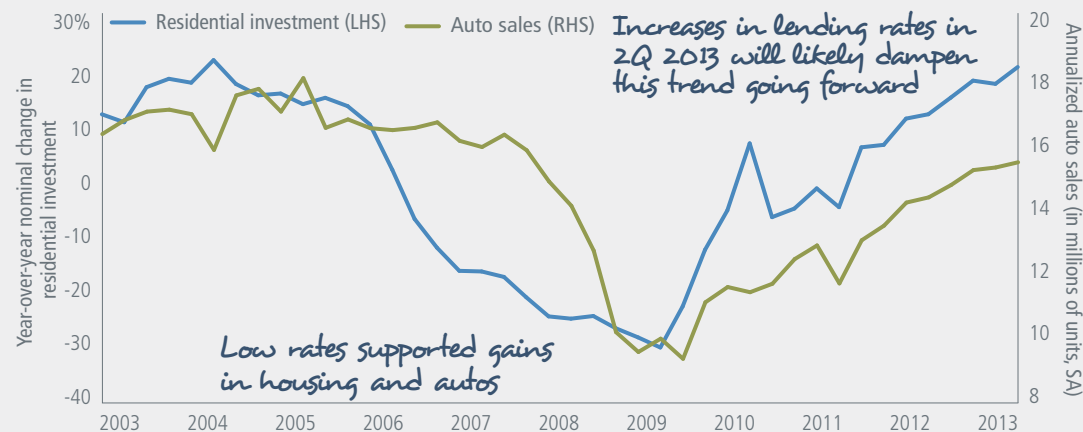
What these charts show

PIMCO is forecasting U.S. real growth of 2.0%–2.5% over the next 12 months, knowing that where the economy goes from here will depend in large part on the handoff from Fed-assisted growth to self-sustaining private sector growth. The near-zero fed funds rate has suppressed market interest rates, motivating consumers to borrow for large expenditures such as homes (blue line) and automobiles (green line). The first chart shows the effect Fed policy has had in supporting these two rate-sensitive sectors of the U.S. economy. Of course, recent interest rate increases will likely dampen this trend going forward. In addition, the second chart shows that broader spending remains weak. Corporate spending on capital goods (blue line) and personal consumption (green line) have been growing at decreasing rates. Private sector spending is necessary to fuel economic growth after policy support is withdrawn.

Investment implications

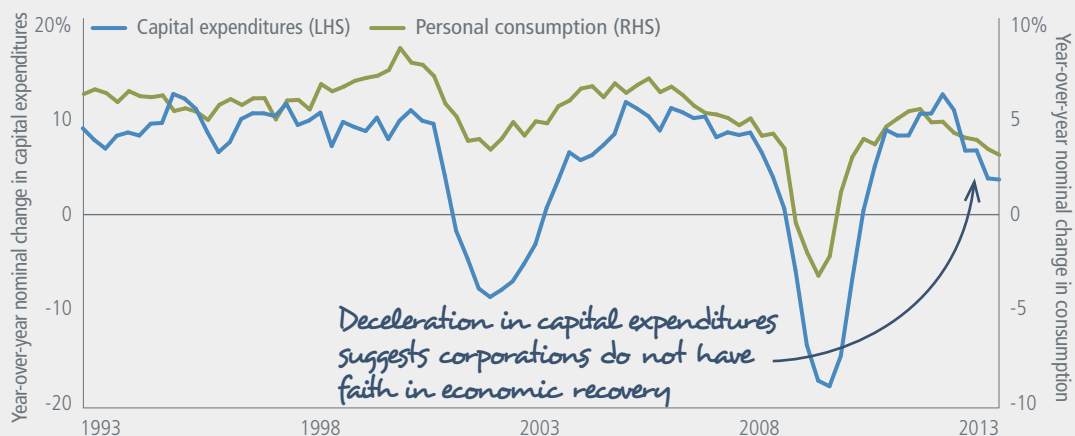
Without the handoff, monetary policy will likely keep the fed funds rate in the zero range for an extended period of time, providing patient bond investors with continued positive returns over cash. In addition, Fed-assisted growth should continue to support credit and equity markets, with opportunities across different sectors of the market.

Fed policy has boosted select areas of the U.S. economy ...



Source: Bureau of Economic Analysis, Ward's Automotive Group. Data through 30 June 2013.

... but broader corporate and personal spending has not picked up



Source: Bureau of Economic Analysis. Data through 30 June 2013.

PIMCO expects slightly improved real growth in Europe, in the range of 0%–0.5%, an increase from the -0.5% contraction over the trailing 12 months.

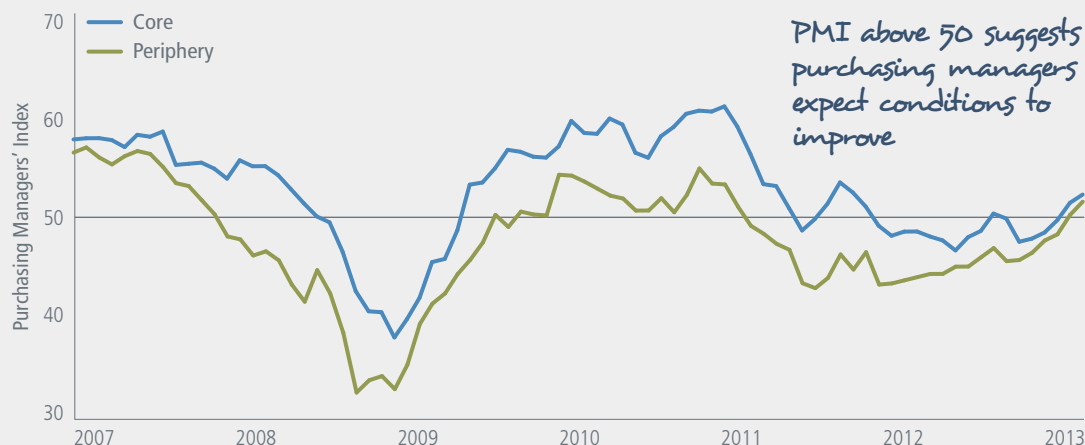
What these charts show

Stability from the European Central Bank (ECB) last summer has continued to reduce the risk of widespread financial crisis and raised confidence in Europe's recovery from recession. The first chart illustrates this, showing an increase in the purchasing managers' index (PMI) for core and periphery countries. PMI is a survey of purchasing managers, about business prospects. Europe's rising PMI, with both core and periphery above 50, suggests manufacturing managers expect the economy to improve. While good news for the economy, there is still a long way to go in terms of the recovery. As the second chart indicates, industrial production levels are very low compared to pre-crisis levels. This reflects the severe structural challenges Europe still faces.

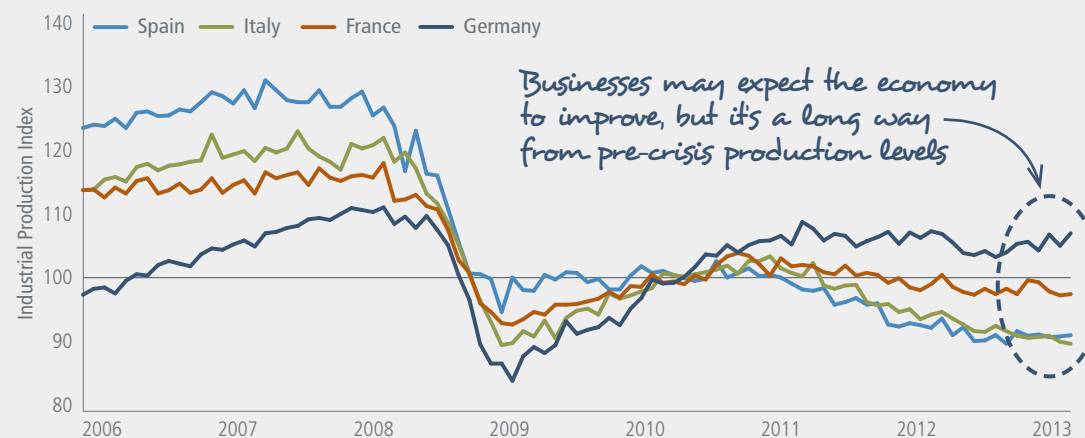
Investment implications

A gradual recovery in Europe presents investors with relative value opportunities in fixed income and equity markets. While growth will be very slow, it may be enough to reduce credit risks in European sovereigns gradually, and raise profit expectations for healthy corporate balance sheets. Investors interested in European exposure should favor an experienced active manager, who can adapt to changing economic and market conditions.

Business confidence has improved ...



... but industrial output remains low



China continues to be the key emerging market economy to follow, with upcoming policy decisions weighing heavily on the outlook for sustained growth.

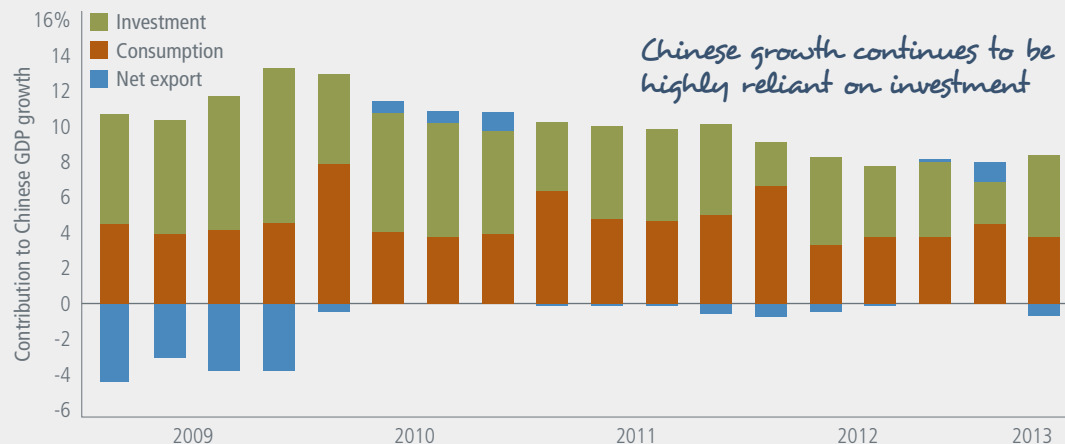
What these charts show

China and the major emerging market countries saw strong but slowing growth over the trailing 12 months. PIMCO expects high-quality emerging markets to stabilize soon, but lower-quality markets will take time and may require assistance from international balance sheets. Tipping the scales may be China. As the first chart shows, China faces a long-term challenge as it seeks to move from an economy driven by investment, production and exports (green and blue bars) to one powered by consumer spending (brown bars). Still, the more immediate outlook looks positive given the recent improvement in sentiment evident in the second chart. Not only has business confidence (as measured by the manufacturing purchasing managers' index, PMI, which is the green line) increased, but the stock market has also rallied (blue line) from recent lows.

Investment implications

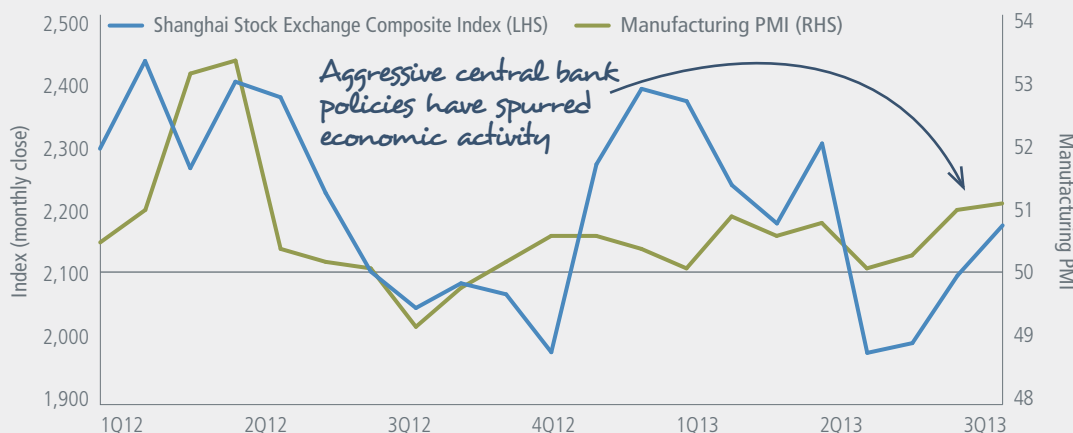
Investment performance in emerging markets will be more differentiated going forward. While EM growth is expected to continue to outpace the world overall, volatility will remain high and returns subject to political and regulatory changes. Fixed income and equity markets remain attractive, but investors should look to active managers with on-the-ground expertise to avoid surprises in specific countries and sectors.

China's transition to a consumption-driven economy is a long-term challenge ...



Source: NBS. Data through 31 August 2013.

... but the cyclical outlook for China is positive



Source: Bloomberg, China Federation of Logistics. Data through 30 September 2013.

Despite concerns that U.S. equities prices are not supported by growth and earnings outlooks, PIMCO sees select opportunities, especially in dividend-paying stocks.

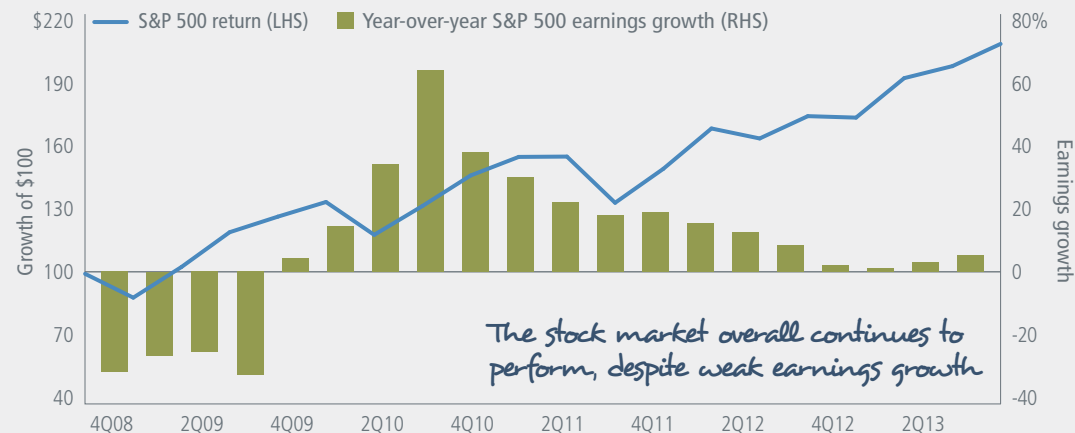
What these charts show

Accommodative Fed policy has boosted U.S. stock prices, in many cases beyond the supporting fundamentals. This is evident in the first chart, which shows market returns (blue line) and earnings growth (green bars). Returns have soared despite slowing earnings growth. Current conditions may support or even drive up prices further in the short term, but PIMCO has longer-term concerns. In contrast, non-U.S. equity markets offer attractively valued opportunities, especially among dividend-paying stocks. Emerging market equities in particular offer better fundamentals, including higher dividend yields, strong earnings growth and attractive valuation entry points. The second chart shows the relatively low price-to-earnings ratio of higher yielding dividend-payers in emerging market countries (brown line) compared to developed countries (green and blue lines).

Investment implications

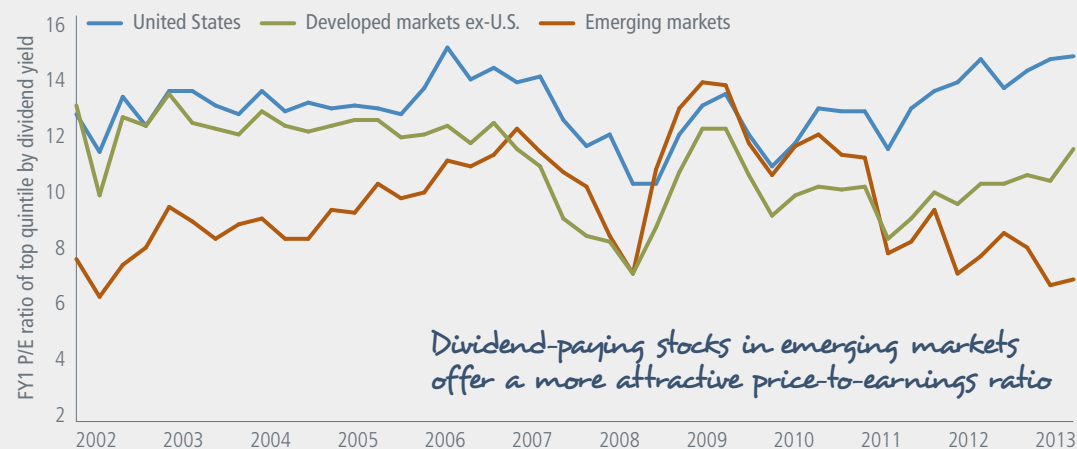
In a low growth world, investors need to broaden their opportunity set. Favor companies with strong fundamentals, including relative low leverage and expanding operating margins, as well as companies poised to deliver upside surprises in revenue growth, and those offering dividends to enhance total return. Select opportunities can be found in Europe, emerging Asia and the U.S.

Stock market strength despite slowing earnings growth



Source: Bloomberg. Data through 30 September 2013.

Investing globally offers the potential for more attractively valued dividend stocks



Source: FactSet. Data through 31 August 2013. Data for each region are represented by the respective MSCI Index.

While we remain optimistic on housing overall, PIMCO has reduced its growth forecast in light of higher mortgage rates and continued tightness in lending standards.

What these charts show

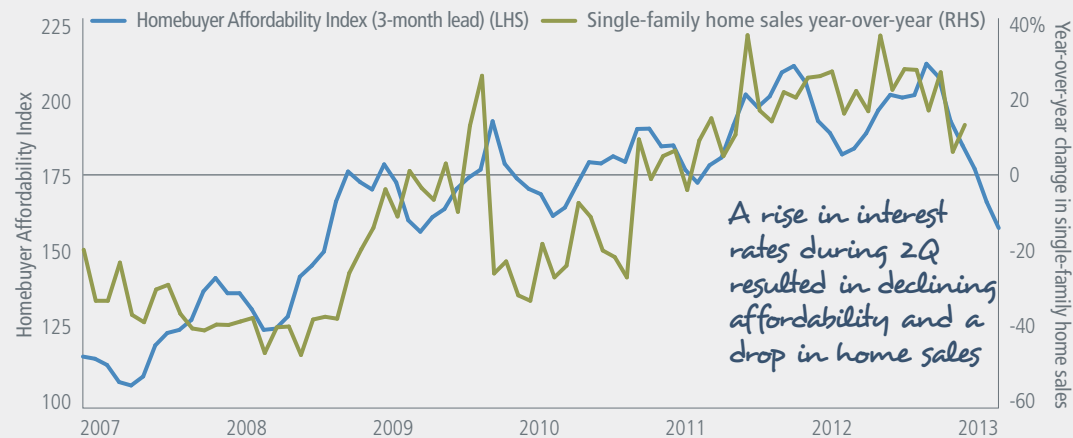
The first chart shows the impact increasing rates have had on the U.S. housing recovery. The blue line is the Affordability Index, which measures whether or not a median-income family could qualify for a mortgage loan on a median-priced home. This index shows a sharp decline in recent months.

The green line is home sales, which fluctuate, but have been trending downward. Given the impact of rising rates, plus continued tightness in lending standards, PIMCO reduced its outlook, forecasting national home price gains of 5%–10% for the next 18–24 months (down from 8%–12%). Despite this revision, PIMCO remains favorable on opportunities in non-agency mortgage-backed securities (MBS). As the second chart shows, non-agency MBS will likely continue to offer attractive loss-adjusted yields across various housing scenarios.

Investment implications

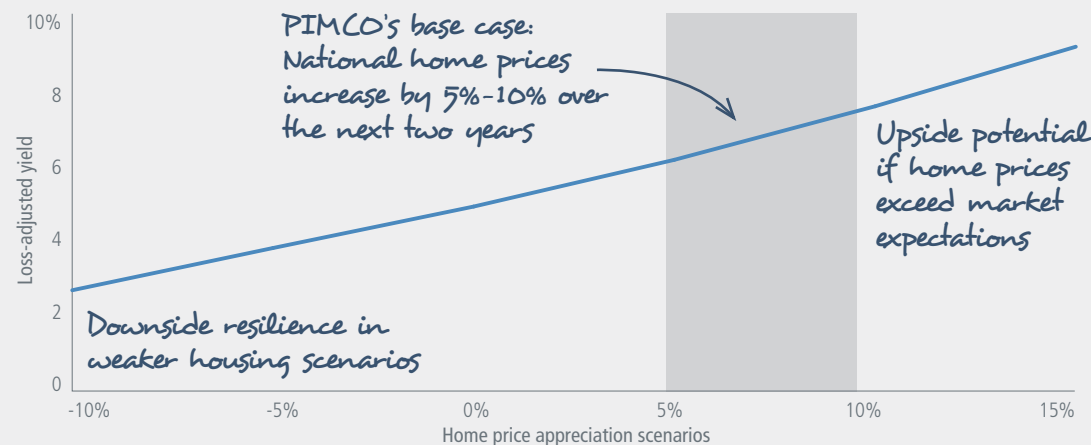
Investors interested in capitalizing on the housing recovery will want to consider exposure to non-agency MBS. Given the shifting rate environment and the complexity of analyzing the housing market recovery, consider a manager who has demonstrated expertise in this area.

Rising rates threaten U.S. housing recovery



Source: Census Bureau, National Association of Realtors. Data through 31 August 2013.

Non-agency MBS are attractive across different recovery scenarios



Source: PIMCO. Data through 10 September 2013. Hypothetical example for illustrative purposes only. Non-agency MBS loss-adjusted yields are based on pricing from PIMCO's survey on the market. Loss-adjusted yields represent the yield earned after expected losses on a specific mortgage bond, across a variety of scenarios. PIMCO's loss-adjusted yield calculation currently factors in the default risk level. The two-year home price appreciation axis illustrates the different home price depreciation and appreciation levels (e.g., -10% represents 10 depreciation).

PIMCO considers much of the U.S. credit market overvalued, but believes there are still attractive risk/reward opportunities for active managers.

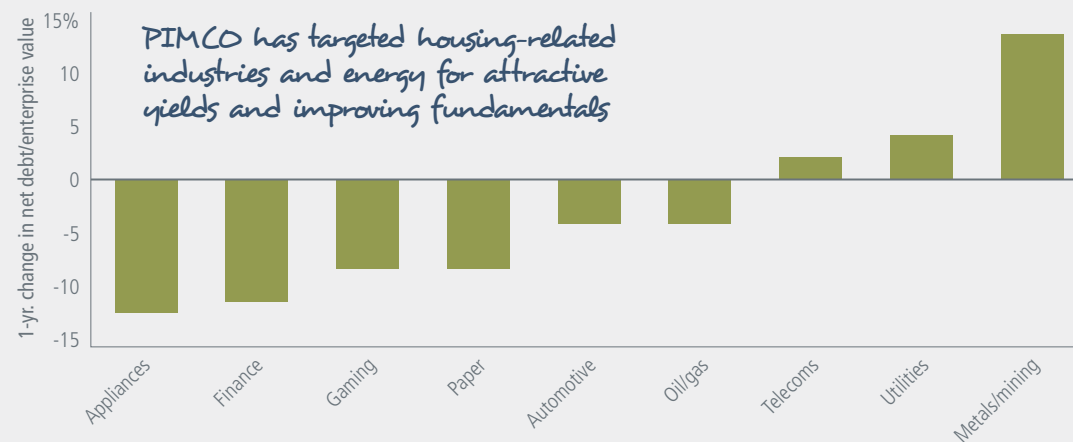
What these charts show

Persistently low Treasury yields drove income investors into the credit market, driving prices up and yields down. While the summer sell-off washed out some of this excess, investors have been returning to high yield since September. Finding attractive opportunities in this overvalued market requires a focus on active credit selection. Growth, for example, is a powerful factor in enhancing profits and reducing debt, both of which increase a company's enterprise value (a measure of total worth). The first chart provides an overview of growing industries (such as appliances, which is benefitting from the housing recovery), showing how these industries have reduced debt relative to enterprise value. As net debt-to-enterprise value falls, a company's credit fundamentals improve. The second chart shows the strong correlation between debt-to-enterprise value ratio (blue line) and tighter credit spreads (green line).

Investment implications

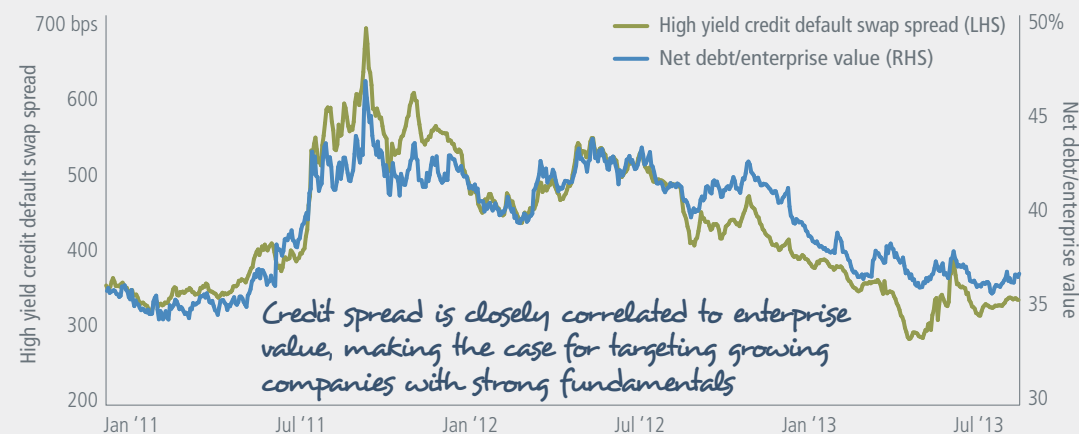
Investors seeking credit exposure will want to focus on high-quality companies in industries growing faster than the overall economy. Identifying these opportunities requires extensive independent analysis, and is therefore best handled by active managers with extensive credit research capabilities.

Deleveraging varies across industries



Source: Bloomberg, S&P Global Industry Classification Standard (GICS) for various sub-industry groups. Data through 7 August 2013.

Credit spreads are linked to enterprise values



Source: Capital IQ, Markit. Data through 30 August 2013.

PIMCO believes that recent volatility in the municipal market has created attractive opportunities to enhance return through active management.

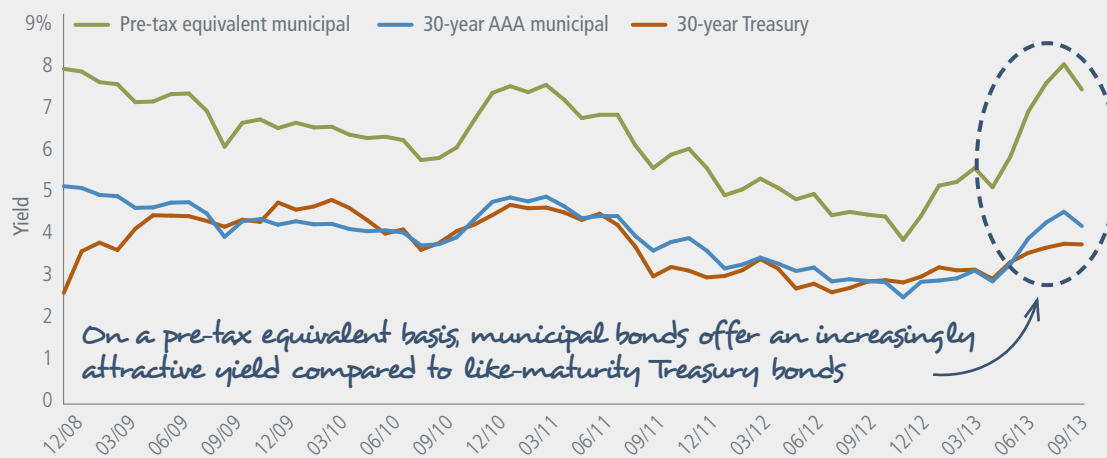
What these charts show

The first chart shows the relatively attractive yield of municipal bonds in recent years. The yield on 30-year AAA municipal bonds (blue line) has been competitive with the yield of maturity-equivalent Treasuries (brown line). Of course, the true value of municipal bonds is on an after-tax basis. The pre-tax equivalent yield of municipal bonds (green line) over this period was consistently superior. Negative headline news in the municipal space has impacted the market, however, as seen in the second chart. Fears of Fed tapering, Detroit's bankruptcy filing and fiscal challenges in Puerto Rico led to unusually strong outflows starting in June. While volatility is never easy for investors, it can provide opportunities to add value. Redemption-related selling out of municipal mutual funds depressed the overall market, allowing active managers, such as PIMCO, to buy high-quality municipals at attractive prices.

Investment implications

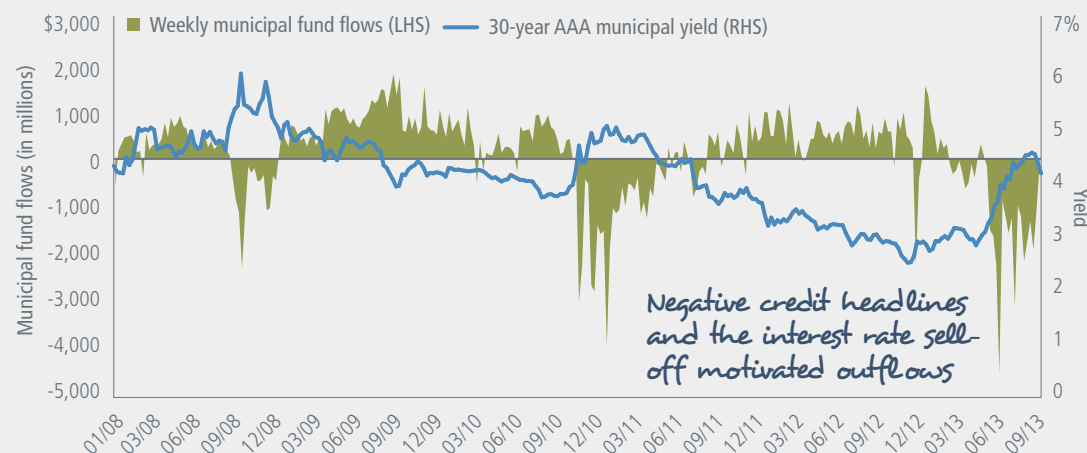
Investors have traditionally treated the municipal bond market as a buy-and-hold asset class. But, recent movement within the market demonstrates the need for comprehensive credit research as well as the value an active manager can add. Investors interested in increasing exposure to the tax-advantaged yields municipals may offer should select an experienced active manager.

Tax-exempt municipals are attractive relative to Treasuries



Source: Thomson Reuters Municipal Market Data for municipal yields, Federal Reserve for Treasury yields. Data through 30 September 2013.

Higher volatility has provided buying opportunity



Source: Lipper for flows, Thomson Reuters Municipal Market Data for yields. Data through 25 September 2013.

Key topics	PIMCO's outlook	Implications
Global economy	Outlook is cautiously optimistic, but below consensus forecast	Focus on country and security analysis as the overall global economy faces persistent headwinds
U.S. economy	Real growth of 2.0%–2.5%	Avoid overreacting to short-term trends, and focus on quality and fundamentals
European economy	Slightly improved real growth in the range of 0%–0.5%	Remain cautious given uncertain nature of the economy
Emerging economies	China is the key to the future of the emerging market economies	Set realistic expectations and seek on-the-ground expertise in order to differentiate between country opportunities
Equities	Select opportunities exist, especially in dividend-paying stocks	Focus on companies with strong fundamentals in Europe, emerging Asia and the U.S.
Mortgages	Remain optimistic on housing overall, but at slower growth rates	Favor a manager who has the expertise and resources to evaluate the complex factors influencing this sector
Credit	Credit in general is overvalued, but attractive risk/reward opportunities still exist	Focus on high-quality companies in industries growing faster than the overall economy
Municipals	Recent volatility in the municipal market has created opportunities to add value	Rely on comprehensive credit research in changing market environment

A word about risk

Past performance is not a guarantee or a reliable indicator of future results. All investments contain risk and may lose value. Investing in the **bond market** is subject to certain risks, including market, interest rate, issuer, credit and inflation risk; investments may be worth more or less than the original cost when redeemed. **Equities** may decline in value due to both real and perceived general market, economic and industry conditions. Dividends are not guaranteed and are subject to change and/or elimination. Investing in **foreign-denominated and/or -domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. **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. **Mortgage- and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government-agency or private guarantor, there is no assurance that the guarantor will meet its obligations. **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. **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.

The value of most bond strategies and fixed income securities are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and more volatile than securities with shorter durations; bond prices generally fall as interest rates rise.

There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

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