P I M C O

Market Update
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Looking Past Volatility

Daniel J. Ivascyn
Group Chief Investment Officer

Scott A. Mather
Chief Investment Officer
U.S. Core Strategies

PIMCO takes a long-term view of markets and economies, one that anchors investment decisions during shorter-term periods of market volatility. Nonetheless, the dramatic return of market volatility has understandably unnerved many investors. On 9 February, Daniel J. Ivascyn, group chief investment officer, and Scott Mather, CIO U.S. core strategies, updated clients on the dynamics at play. They discussed both the short-term, cyclical phenomena of the past week and the long-term, or secular, factors stretching out multiple years. They also address positioning portfolios for what's ahead.

VOLATILITY IN PERSPECTIVE

The backdrop for the spike in volatility is more cyclical than secular in nature and unique to this business cycle. The main point to consider is that we are, finally, returning to normal levels of volatility.

- The U.S. economy is running close to capacity, and we are seeing a historically large dose of fiscal stimulus late in the cycle. This has implications for economic growth and inflation.
- The recent budget deal in Washington further demonstrates Congress is willing to allow deficit spending.
- At these levels of volatility, we do not anticipate a spillover into the real economy. However, volatility is likely to persist, and that could increase the risk of such a spillover over time.
- Volatility is a function of starting valuations, which have been somewhat stretched in equities and certain segments of the fixed income markets. So markets are more easily spooked by negative news.
- Credit is less volatile than equities, but this masks some risks and weaknesses in credit markets that could create opportunities for investors.

THE MACRO VIEW: THE FED AND INFLATION

Our secular view since 2009 has been that we are in a New Normal, later revised to The New Neutral, global environment characterized by strong disinflationary pressures and relatively low and stable economic growth.

- We still hold this New Neutral view, though we regularly test the thesis in discussions with colleagues and with our expert advisors.
- Our base case is for the global economic expansion and inflation to continue at a moderate pace.
- However, we recognize near-term inflation risk is a legitimate concern for investors.

- We expect fiscal stimulus will add a slight boost to the U.S. economy, and inflation might meet or exceed the Federal Reserve's target this year.
- Recent market events have not meaningfully affected the real economy, and with fiscal stimulus in place, we believe the Fed will make three hikes that will take the neutral rate to the low 2's by the end of 2018.
- Looking more broadly, even if we see localized inflation overshoots in parts of the world, which could lead to local higher interest rates, we do not expect a breakout in inflation that prompts a paradigm shift or runaway interest rates.

PORTFOLIO IMPLICATIONS: A FOCUS ON MANAGING RISKS AND SEIZING OPPORTUNITIES

Risk management is a central focus of discussion in the Investment Committee. We are continually stress testing portfolios and planning our response – both defensive and offensive – for volatility spikes. Input to our discussion is global, coming from PIMCO professionals in several countries, as well as outside experts, including our Global Advisory Board chaired by former Chairman of the Federal Reserve Ben Bernanke. We have been gradually reducing risk across portfolios, increasing liquidity and watching for opportunities created by volatility.

The impact on core bond portfolios:

- 10-year yields are not likely to rise much above 3%.
- The increase in yields has led to fairer values in the short end of the curve, but less so in the long end where more repricing is likely due to higher inflation expectations, the return of term premia and concerns about fiscal deficits.
- We see value in high quality U.S. bonds in the belly of the curve, while the mortgage sector in general also is attractive.
- There has been some repricing of corporate credit, but we remain defensive due to potential additional spillover from the equity market.
- Inflation-linked securities have done well the past several months but remain attractively priced, though we are mindful to monitor the effect of volatility.
- Although we see some opportunities arising from volatile markets, we are broadly cautious in fixed income.

The impact on income strategies:

- We remain cautious on duration, although rates will likely remain range-bound.
- We have been maintaining high allocations to high quality bonds in the U.S. and Australia (which could provide some hedge against a slowdown in Asia, China in particular).
- We believe housing-related investments remain attractive even with higher rates – the market is highly regulated, lending is not aggressive and fundamentals are relatively strong, especially compared with the corporate sector.
- We do not foresee a recession in the near term and believe defaults will remain low, but given expectations of heightened volatility, we are especially selective in generic corporate credit.

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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 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. **Corporate debt securities** are subject to the risk of the issuer's inability to meet principal and interest payments on the obligation and may also be subject to price volatility due to factors such as interest rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity. **Inflation-linked bonds (ILBs)** issued by a government are fixed income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise**. 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. 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. **Diversification** does not ensure against loss.

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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57003

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

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