PIMCO

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Global Credit Perspectives

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All Eyes on Europe

The question on everyone's mind these days is whether policymakers can contain the European sovereign debt crisis. Europe has roughly the same amount of government debt as a percentage of GDP as the United States. However, the magnitude of Europe's total debt is not the issue in our opinion, it is the distribution. Germany has a lower, sustainable debt level whereas some peripheral European countries do not, particularly at current interest rates. As part of Europe's entire Economic and Monetary Union (EMU), participating countries don't have the benefit of an independent currency and monetary policy. This means countries with higher debt lack the ability to devalue their currencies in an attempt to improve exports. Monetary policy is also set for the EMU by the European Central Bank (ECB), which limits options for peripheral countries needing more accommodative policies. For many peripheral European countries these factors are major headwinds to growth which means to stay competitive these countries must move forward with structural reform. Yet, significant fiscal austerity and reform may prove so challenging that a few of the most leveraged European peripheral countries, like Greece, may have to restructure and leave the Euro in order to restore competitiveness and debt sustainability. Ultimately, Germany and Europe's other strong sovereign balance sheet nations will have to make a choice: continue to provide financial assistance to countries with more debt and assist in helping restructure the debt of some European peripheral countries in order to keep the EMU intact, or potentially move forward with a smaller, stronger group of countries – or at the extreme even walk away from the Euro and the European Union.

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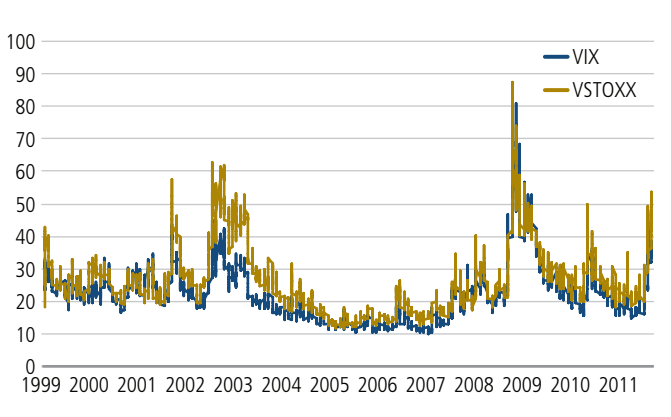
"The longer policymakers wait, the more likely Europe's financial crisis will deteriorate."

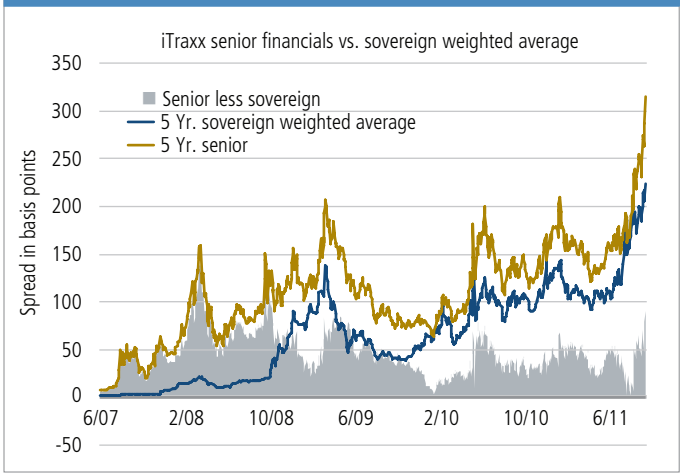
The importance of the European sovereign debt crisis should not be underestimated. Simply put, Europe remains a main driver of "animal spirits" and volatility (see Figure 1) in financial markets and can significantly shape the outlook for the global economy. The risks associated with the sovereign debt crisis are significant. What was initially perceived as a liquidity crisis is increasingly becoming a solvency crisis for a growing list of European countries. Timing is critical as financial markets appear to be moving faster than policymakers' ability to come up with a credible solution.

Figure 1: Financial markets volatility has increased



Source: Bloomberg, as of 15 September 2011

Figure 2: European banks exposed to deteriorating sovereign credit



Source: Morgan Stanley Research, as of 12 September 2011

As interest rates increase on higher-debt European countries in the south, debt sustainability will be increasingly tested. The fact that financial markets are effectively marking-to-market European government bonds and interest rates in real time means the European financial crisis is spreading quickly into their banking system since many banks have large exposure to European sovereign debt. While central banks have provided liquidity support so banks can get short-term funding, a fiscal and growth solution is needed to restore confidence in vulnerable European sovereign balance sheets as well as in numerous European banks (see Figure 2), which increasingly appear under-capitalized and exposed to deteriorating sovereign credits.

Balance sheets not engaging

The longer policymakers wait, the more likely Europe's financial crisis will deteriorate. And, all eyes are on Europe now for good reason because the risk of a global liquidity trap has increased as many healthy balance sheets around the world are also refusing to engage. Multinational companies which have low leverage and high cash balances aren't aggressively spending and hiring due to an uncertain outlook. Emerging market sovereign balance sheets have yet to commit to provide significant financial assistance to Europe as these nations want to see a united Europe and clarity from policymakers, mainly from the German government, given the country's leading role in shaping policy for the region. While the healthiest sovereign balance sheets in Europe have the ability to help, many appear to lack the will. As an example, many Germans want to see more austerity, significant deficit reduction and structural change in peripheral countries before they increase financial support beyond current commitments. Yet, too much deleveraging at once could throw Europe into a severe recession which would have significant negative implications for the global economy.

On the policy front, a wait-and-see or "conditional love" approach to solving the European crisis will not be effective

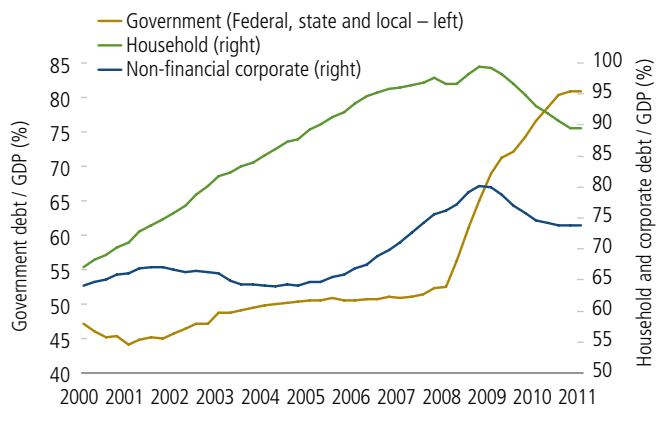
in our opinion given that the asset sides of European banks' balance sheets are being marked-to-market in real time by financial market participants who seem to increasingly fear the unknown and refuse to take heightened levels of risk. We believe European policymakers should take several actions to help restore confidence in markets. First, policy makers should make clear which European sovereigns will be backed unconditionally through explicit guarantees and assist those sovereigns whose debt will ultimately be restructured. Second, the European Financial Stability Fund (EFSF) should be converted into an equity funding vehicle which can re-equitize banks and provide term financing to solvent European sovereigns at interest rates which allow for sustainable debt service. Third, while many European peripheral countries will likely need to embrace significant budget cuts and challenging austerity measures, policy leaders should balance higher taxes and spending cuts with pro-growth structural reform which promotes privatization and allows for workers to remain productive and employed longer given the need to increase retirement ages. Fourth, a few of the highest debt European peripheral countries deemed to be insolvent may have to exit the EMU and Euro currency in order to restore debt sustainability and competitiveness. Finally, the ECB should ease monetary policy and stand more aggressively behind solvent European sovereigns by acting decisively as a lender of last resort.

Without bold and coordinated action from European policymakers and the ECB, we can expect financial markets to remain on edge; causing volatility to remain elevated until equity capital is injected into weaker European banks and permanent term financing is provided to those solvent European peripheral sovereign countries. In the meantime, we expect the global banking system and other balance sheets around the world will continue to hoard cash. Without a unified Europe and a bold plan of action, we face the risk of a global "paradox of thrift" where balance sheets won't engage and credit creation will remain restricted without stronger fiscal commitments. This ultimately puts Germany and the other northern European countries in the driver's seat in influencing whether or not the EMU will remain together or break apart. Yet, the longer Europe's crisis lingers the more likely we could experience a disorderly outcome.

Global growth slowing

The timing of the European sovereign debt crisis could not be worse as global economic growth is already slowing in both the developed and developing world. In developed economies, fiscal policy may be less able to offset a deleveraging private sector as government debt has reached a high enough level in many developed countries that fiscal stimulus is simply not an option. In the U.S., total federal, state and local government debt has increased from 53% of GDP in the 2nd quarter of 2008 to 81% today (see Figure 3). While some may argue the U.S. still has some near-term ability to stimulate fiscally, growing political opposition to deficit spending and political gridlock, combined with the need to reduce longer-term deficits, suggest that going Keynesian in a major way is increasingly unlikely. Given these conditions, fiscal policy in many regions of the developed world is becoming a less viable option.

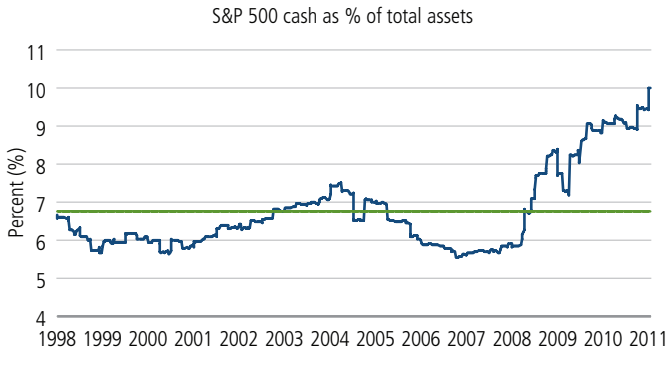
Figure 3: Public sector balance sheets deteriorating



Source: Haver Analytics, as of Q2 2011

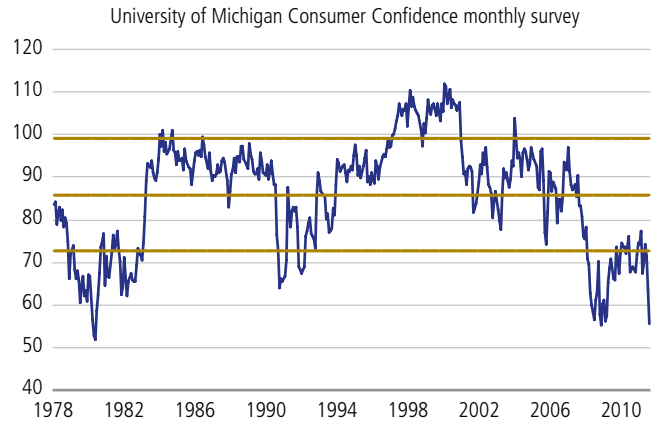
In addition to constraints on the fiscal side, monetary policy is also becoming less effective in the developed world due to what many believe has become a liquidity trap, particularly in the U.S. As an example, multi-national companies in the U.S. continue to focus on hoarding cash (see Figure 4) and re-building balance sheets while consumers increase savings, pay down debt and remain extremely pessimistic (see Figure 5). With companies concerned about an uncertain outlook in Europe as well as a delevering consumer in the developed world, the outlook for hiring and capital spending will likely remain challenging. As such, we believe monetary expansion is less effective in developed economies that lack aggregate demand and animal spirits. Simply put, many balance sheets in the developed world are refusing to engage due to an uncertain outlook. Overall, we expect real economic growth in developed economies to approach stall speed or zero over the next year due to weak consumer and investment spending as well as governments transitioning into a headwind to economic growth because of their stretched public sector balance sheets.

Figure 4: Multi-national companies hoarding cash



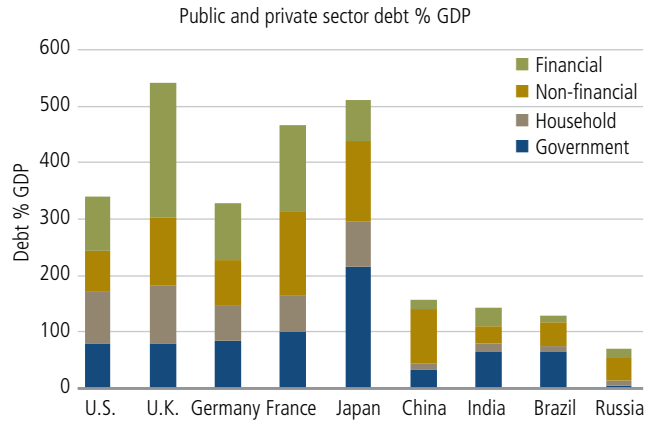
Source: Bloomberg, as of 15 September 2011 and includes financials

Figure 5: Consumers pessimistic



Source: University of Michigan Survey Research Center, as of 15 September 2011

Figure 6: Emerging markets less levered



Source: Data for U.S., U.K., Germany, France and Japan from Haver Analytics and PIMCO estimates as of Q1 2011. Data for China, India, Brazil and Russia from the McKinsey Global Institute, as of Q4 2009.

In the emerging markets, countries such as China, which went Keynesian in 2009 through an enormous fiscal stimulus program targeting infrastructure, now appear focused on a longer-term transition toward domestic consumption in order to prepare their economies for more balanced growth and stability over a secular horizon. In addition, policy makers want to keep inflation under control. As such, Keynesian fiscal stimulus on a global scale appears less likely in emerging markets. In fact, emerging market leaders appear hesitant to put their sovereign balance sheets at risk in providing financial support to Europe without more clarity and certainty. While countries in emerging markets have significantly less public and private sector debt (see Figure 6) than in the developed world, their economies will likely be

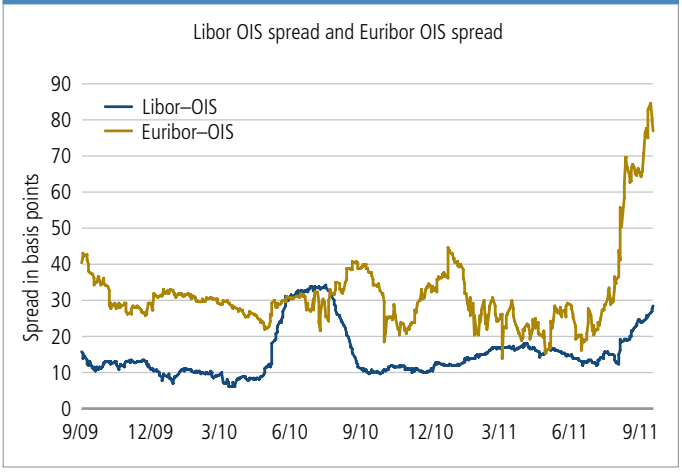
negatively impacted by weaker growth in developed economies. While a weaker global growth outlook could lead to more monetary stimulus in emerging market economies, we expect real economic growth to slow in the emerging markets to a level of roughly 4–4 ½% (with the large economies of Brazil, Russia, India, China and Mexico expected to grow at a combined 5–5 ½% real rate) over the next year due to weaker export and investment growth.

Investing in an uncertain world

European sovereign concerns, an increasingly fragile European banking system and slowing global economic growth suggest investors should consider a more defensive and conservative approach. Balance sheets around the globe are watching whether European leaders have the ability and willingness to restore confidence in both European sovereign balance sheets as well as in European banks.

We believe investors should wait to see whether policymakers can be effective in formulating a coordinated and credible solution for Europe before taking on more risk. The ECB and other central banks are helping to inject liquidity into the system, which is providing near-term support for European banks. Nevertheless, banks generally remain extremely hesitant to lend to one another (see Figure 7). In addition, without a fiscal solution, the capital needs of European banks will likely remain unresolved as investors will watch the prices and yields on European government bonds, a major holding on bank balance sheets, adjust in real time.

Figure 7: Lack of trust in European banks



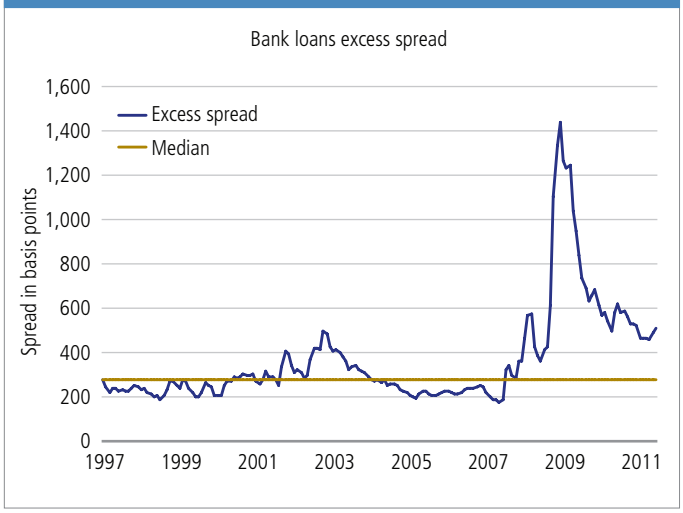
Source: Bloomberg, as of 15 September 2011

The uncertainty caused by the lack of clarity surrounding whether or not European peripheral government debt is "money good" or not will keep investors on the sidelines. European governments with significant debt levels as well as European banks with exposure to weaker European sovereigns are increasingly likely to be cut off from the capital markets until a credible and decisive fiscal solution evolves. This will likely negatively impact the flow of credit in the private sector by tightening credit availability and raising borrowing costs in an economy which is already fragile.

What to do?

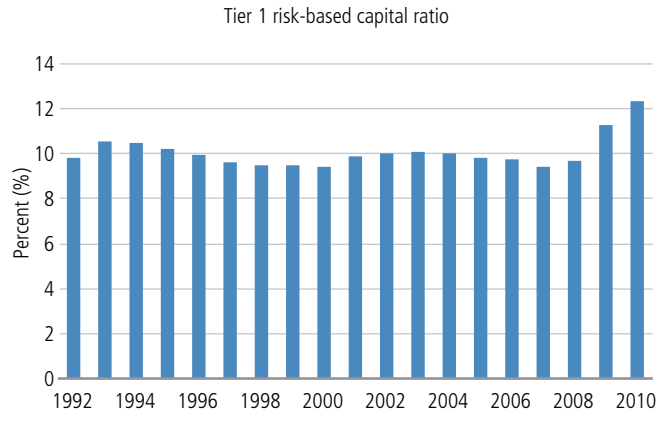
In the near term, we believe a higher-than-normal cash balance focus and favoring select investments in areas where fundamentals remain healthy to be attractive.

Figure 8: Bank loans attractive



Source: Credit Suisse, JPMorgan, spread is represented by the Credit Suisse Leveraged Loan Index; as of 31 August 2011

Figure 9: Fundamentals improving for U.S. banks



Source: Barclays Capital, as of Q4 2010

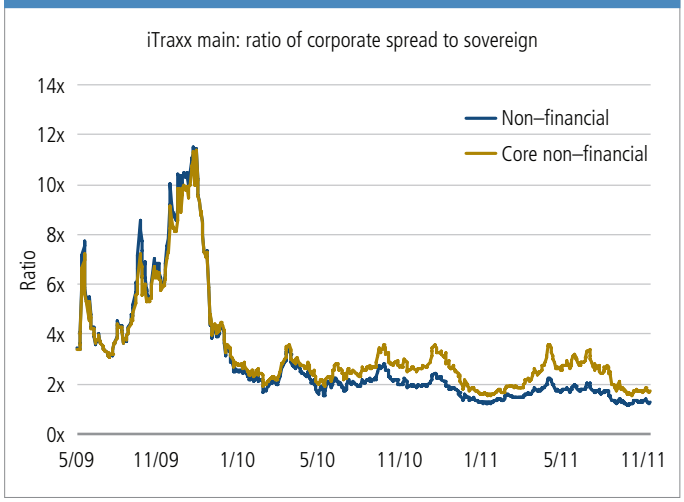
Specifically, we believe investments in the following select areas deserve consideration:

- The equities and debt in select multinational companies with strong balance sheets
- Emerging market equities and sovereigns, and corporates where growth remains supportive
- Bank loans (see Figure 8) and senior secured debt with significant asset coverage
- U.S. bank debt (senior) given strengthening capital and balance sheets (see Figure 9)
- High quality municipal bonds in states with strong balance sheets and in essential services such as water and sewer, power and airports
- Hard assets and resources with favorable demand and supply dynamics

Despite an uncertain global macro environment, we are finding some opportunities in the above sectors where we feel valuations are compelling. We believe investments in these areas have the potential to increase a portfolio's yield by owning what PIMCO refers to as "safe spread." In an environment where the 10-year U.S. Treasury is yielding less than 2%, we are finding that select credit investments with strong fundamentals can potentially increase those yields while maintaining a defensive posture. The above areas are specific sectors where we believe growth and balance sheets are strong, credit fundamentals are stable-to-improving and valuations are compelling.

Given a slower growth outlook, we favor BB-rated credits in the high yield market as opposed to CCC-rated and highly levered companies. In addition, we believe credit risk should be taken at the top of the capital structure as well as in non-cyclical, defensive sectors. Our credit analysis is focused on stress testing companies and investments in a slower global growth environment where the risk of recession has increased. In addition, our research is focused on a company's sources and uses of cash, debt maturity profiles and cash flow analysis. We believe less leveraged companies with high cash balances and low near-term funding needs should perform well. We favor U.S. credit within the developed markets, particularly relative to European credit (see Figure 10) as their corporate credit trades too tight relative to the sovereign. Emerging markets are favored over developed markets given stronger balance sheets and a healthier growth outlook.

Figure 10: European credit expensive relative to sovereign



Source: JPMorgan, as of 6 September 2011

All eyes on Europe

Given slowing global economic growth and significant uncertainty surrounding the European sovereign debt crisis, we believe it is wise to take a conservative and defensive stance. For many reasons previously discussed, both public and private sector balance sheets are not engaging and are instead taking a wait-and-see approach. High public sector debt in many developed economies has led to a lack of will to go more Keynesian. Importantly, this isn't just a public sector issue. Healthy balance sheets which appear to have the ability to stimulate are currently not engaging. As evidence, many companies are hoarding cash, which we believe is increasing the risk of a global "paradox of thrift" where higher saving and lower spending suggest a more challenging outlook for global economic growth. This dilemma, combined with what many have described in the U.S. as a liquidity trap, further explains why fiscal and monetary policy have become less effective in the developed world where the private sector lacks animal spirits and continues to delever.

The lack of policy coordination and a unified front in Europe combined with increasingly stretched sovereign balance sheets in the developed world are proving to be significant challenges for the global economy. It also suggests politics may increasingly influence outcomes, financial markets and the economic outlook. In our opinion, the effectiveness of policymakers should also be questioned given that fiscal and monetary stabilizers appear to have become less useful in a world which continues to lack confidence and faces significant uncertainty, particularly in developed economies where aggregate sovereign debt levels remain elevated and where fiscal stimulus is becoming less viable.

The combination of political, economic and policy implementation risks all argue for maintaining a conservative, defensive approach. We believe investing in a world of heightened uncertainty means maintaining higher cash balances than normal, focusing investments in areas with strong fundamentals and balance sheets and staying defensive in non-cyclical sectors as well as in investments senior in the capital structure. When looking to increase risk, we will remain patient and continue to focus on Europe for signals as to whether or not European policymakers can establish a united front, act decisively and deliver on a bold, sizeable and coordinated solution to the European sovereign debt crisis. In the meantime we focus on select investments where fundamentals remain supportive; such as equity and debt in select multinational companies, emerging market equity, sovereign and corporate debt, bank loans and senior secured debt, U.S. bank debt at the top of the capital structure, high quality municipal bonds and hard assets and resources with favorable demand and supply dynamics.

Mark Kiesel
Managing Director

23 September 2011

"Safe Spread" is defined as sectors that we believe are most likely to withstand the vicissitudes of a wide range of possible economic scenarios. All investments contain risk and may lose value.

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