

# PIMCO's Perspective on the Recent Market Turmoil

P I M C O

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Global financial markets have experienced historic turmoil in the past few days in the wake of the Lehman Brothers bankruptcy, the sale of Merrill Lynch and the heightened liquidity concerns over AIG that led to that insurer being taken over by the U.S. government. In this update, PIMCO Co-CIOs Bill Gross and Mohamed El-Erian outline PIMCO's view about how this "disorderly redefinition of the U.S. financial landscape" is likely to affect investors.



Bill Gross and Mohamed El-Erian,  
PIMCO Co-CIOs

For a glossary of financial terms,  
see page 3.

## How did the U.S. financial system arrive at this chaotic state?

- Since World War II, financial innovation has brought new and increasingly complex investment products into the marketplace.
- The innovation process crested in the beginning of the 21st century, with exuberance building in the financial industry and fueling growth of structured products, highly levered hedge funds, mortgage giants Fannie Mae and Freddie Mac and others.
- While the ongoing financial crisis initially appeared to be confined to the sub-prime mortgage market, it quickly expanded into a full-blown credit and liquidity crisis that ultimately affected all leveraged holders of all assets. As the crisis spread, it led to the current deleveraging process and resulted in asset deflation, a process which continually threatens to spiral into a vicious cycle.
- There are three primary consequences of the deleveraging process in the global financial markets:
  1. Risk premiums across all asset classes — stocks, bonds, mortgages, etc. — have become extremely wide. Liquidity premiums have also widened considerably, even for the highest-quality assets, as evidenced in the current wide spreads between Treasury Inflation-Protected Securities (TIPS) and nominal Treasuries.

2. Volatility has increased across all global financial markets.

3. Term premiums for taking risk beyond a day have also risen.

- Consequently, in contrast to the prices of the most liquid asset — Treasuries, prices of all other assets, including stocks, non-government bonds, real estate and even commodities, fall.
- Deleveraging will only slow or stop if one of two significant conditions are met:
  1. All assets have been liquidated.
  2. Sufficient capital has been raised, or a big enough new balance sheet absorbs assets as quickly as they are being liquidated and thus creates equilibrium.

## Describe the current policy environment and how PIMCO's investment process accounts for the myriad implications of a constantly evolving marketplace.

- The PIMCO Investment Committee attempts to look at the world from the perspective of policymakers who are confronted with:
  - A crisis at the heart of the global financial markets;
  - A disorderly redefinition of the financial landscape and;
  - Negative feedback loops, which are a policymaker's nightmare: Institutional problems become sector problems, which then become a system problem.

- In this environment, policy response becomes a marginal price setter for risk assets.
- So far, policy has been “too little, too late.” The “Sunday Night Specials” — opening windows at the Fed, the \$29 billion bailout of Bear Stearns, the roughly \$200 billion bailout of Fannie Mae and Freddie Mac — have not resolved the crisis.
- A major problem is that policy remains focused on liquidity and not capital. Policymakers have created liquidity firewalls, but they are breaking down because the fire is out of control.
- The hesitancy of policymakers to use a capital response stems from:
  - An insufficient and delayed understanding of the problem;
  - A reluctance to pick “winners” and “losers” in the marketplace by injecting capital;
  - The specter of “moral hazard” and;
  - Fear of suffering politically for the cost without adequate results.
- PIMCO's investment process accounts for both the risks and the opportunities in financial markets by:
  1. Focusing on elements of portfolio management that are not readily visible to observers, such as cash management, collateral management and counterparty risk management;
  2. Recognizing that policy “can't do it all” and;
  3. Accepting that there cannot be a generalized strategy covering all sectors, because policy responses will have a different impact on different sectors, disproportionately benefitting the ones directly under the Fed's policy “umbrella.”
- PIMCO expects policymakers to recognize that further action is necessary.

### How have PIMCO's portfolios been positioned and how does PIMCO seek to position them going forward?

- Over the past year and a half we recognized the deleveraging process would dominate the U.S. markets.
  1. We believed that central banks would respond to the crisis by lowering interest rates, if only to rejuvenate stagnant growth, and we concentrated on the front ends of global yield curves.
  2. Portfolio managers have focused on high-quality assets of issuers we assume to be under the policy umbrella, particularly those “closest to the handle.”
  3. In the U.S., we expected policymakers to come to the rescue of the housing market, and we bought mortgage-backed securities.
- PIMCO was premature in our purchases of bank capital when yields were extremely attractive, at 7%–9% coupons. While this exposed us to the worsening situation in the financial sector — in particular, the collapse of Lehman Brothers — our hedges against just this type of tail risk performed as we expected in the resulting flight to quality.
- The work that we do on counterparty risk and collateral management also puts us in a position to quickly inventory our counterparty exposure, terminate ISDA agreements and reconstitute swap exposures when necessary.
- We are no longer a buyer of bank capital and are also content with mortgages and our positioning at the front end of the curve.
- PIMCO is maintaining a high-quality defensive position, focusing with the liquidity we need to allow us to pick up tactical exposures to various risk factors as they become attractive.

### The Bottom Line

PIMCO believes that its investment process, which focuses on cyclical and secular risks and opportunities, is at the core of its ability to provide global investment solutions and effective risk management, particularly in times of economic and market stress.

## Glossary

**Collateral**—assets that are offered to secure a loan or other credit.

**Counterparty risk**—the risk to either party in a financial transaction that the other party will not be able to fulfill its contractual obligations.

**Deflation**—a general decline in price levels.

**ISDA**—International Swaps and Derivatives Association, Inc., a global trade association for over-the-counter derivatives.

**Leverage**—the use of borrowed funds to finance a portion of the cost of an investment.

**Liquidity premium**—the additional return that is associated with securities that are less readily bought and sold in a secondary market to compensate investors for accepting reduced liquidity.

**Risk assets**—assets that typically command a risk premium (see below).

**Risk premium**—the return in excess of a risk-free rate (typically represented by the interest rate on the three-month Treasury bill) that a riskier investment is expected to yield.

**Spread**—the difference between the yields of two bonds. Typically, a bond with a certain amount of risk is compared to a like-maturity U.S. Treasury Bond, which is considered to have no credit risk.

**Structured products**—in general, prepackaged investment strategies that are based on derivatives.

**Subprime mortgages**—in the U.S., mortgage loans that do not meet the conventional guidelines of Fannie Mae and Freddie Mac, and therefore entail a higher expectation of risk.

**Swap**—an agreement between two parties to exchange one stream of interest payments for another, over a set period of time. Swaps are derivative contracts and trade over-the-counter.

**Tail risk**—the probability that the return of an investment will move more than the normal distribution's expected two to three standard deviations from the mean. Simply stated, it is the probability of an extreme, but unlikely, outcome.

**Term premium**—the additional return that is associated with longer-term bonds to compensate investors for the added risk of having their money tied up for a longer period, including the greater price uncertainty.

**Yield curve**—a line graph that plots the relationship between yields and maturity dates for bonds of the same asset class and credit quality. The plotted line begins with the rate for the shortest maturity and extends out in time, typically to 30 years.

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