Allianz Global Investors

Gaining Perspective
Market Insights from PIMCO

Why PIMCO Finds Investment-Grade Corporate Bonds Compelling Today

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1/27/2009—In a conference call, Mark Kiesel, head of PIMCO's investment-grade corporate desk, discussed current opportunities in this asset class. The following is an excerpt of the call.

We are bullish on investment-grade corporates
PIMCO has been involved in the credit markets since our inception as a firm, and we have always tried to anticipate long-term opportunities and risks ahead of our competitors. That said, we have not liked corporate bonds since 2002—yet over the last six months, we have increasingly become more bullish on the investment-grade corporate market.

A lot of this has to do with their attractive current valuations relative to other asset classes, thanks to the massive long-term deleveraging that is still unfolding. We see serious economic headwinds ahead, particularly for the U.S. consumer and U.S. companies. Our top-down macro view suggests that we are in the intermediate stages of what will likely be a four- or five-year deleveraging cycle, which is reflected in our views on housing. Housing peaked in 2006 and may not bottom out until 2010 or 2011. Banks are being very cautious, and the Troubled Assets Relief Program (TARP) money is essentially not re-circulating into the system.

We are focused on high quality, not high yield
Nevertheless, with corporate bonds offering extremely wide spreads over Treasuries—in some cases spreads that approach 20- and even 75-year highs—opportunities abound in this environment. But PIMCO is picking only high-quality investment-grade bonds of companies with what we believe to be solid balance sheets, instead of what we think are weaker high-yield companies with a lot of senior debt on their books.

This is in large part because we believe the default rate is going up in corporate bonds in general—in some investment-grade corporates, but particularly in high-yield corporate bonds—and we expect poor recoveries on the junior parts of the capital structure for high-yield companies.

We favor seniority in the capital structure
With all these conditions in place, PIMCO believes that investors need to be cautious. And clearly, the risk/reward relationship currently favors seniority in the capital structure—i.e., being in credit, which is at the top of the capital structure, and not in equities, which are at the bottom.

Why? Because we believe ongoing deleveraging will keep the U.S. economy in a period of sub-trend growth for an extended period. This is likely to keep U.S. monetary policy highly expansionary, and would force policymakers to support credit markets in unconventional ways. And that very same government support will likely come in above equity in the capital structure. So equity runs the risks of seeing dividend cuts and being subordinated by additional capital coming in above it.

And that is where PIMCO is looking right now: at securities with current yields of 7%-8%—before factoring in any potential price appreciation that may increase total return—in the senior part of the capital structure. In many cases, we are finding these yields in sectors that the government is supporting. These are securities that are potentially offering equity-like returns, yet they are positioned favorably to equities. Of course, while equity investing involves certain risks, fixed-income investing also involves risks—including market, interest rate, issuer, credit and inflation risk.

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We are finding select opportunities in banks, but not cyclicals
In order to understand where we are investing, it is important to understand that we believe we are in a massive, long-term deleveraging cycle. We do not expect the consumer, housing prices or the traditional lending/credit/securitization markets to come back anytime soon.

That is why we are focusing on policy responses around the world: what governments are likely to do, what they can do and what is realistic for them to do.

Our conclusion is that there are certain industries and sectors that we think are mission-critical and will be supported, and there are those that will come under significant pressure due to these secular problems that we have discussed.

As a result, we are very cautious on consumer cyclicals—gaming, lodging, retailers, housing, etc. We believe defaults rates will increase with these companies, which have historically been very cyclical in nature and have limited policy support.

Conversely, we believe the banking system will continue to be supported by monetary and fiscal policy. But not all banks. For every bank we are buying, there may be 10 or 20 we are not. However, we think select, global, “too-big-to-fail” institutions with large depositors are mission-critical, and we believe they will get the necessary support from central banks and governments around the world.

Aside from banks, there are other sectors that we think make sense in this environment—pipelines, utilities, healthcare, telecom, cable, etc. There are even some energy companies right now that we have actually started to look at, given the extremely wide spreads.

We are buying at or above the level where the government is buying
As for banks, remember that much of the original TARP money went into larger financial institutions at the preferred equity level, which is junior to bonds. The result is that this money is basically only senior to equity. This is where we think future money will likely go as well. So what PIMCO is doing is investing in investment-grade corporates at the top of the capital structure, while the government’s money is going lower in the capital structure.

Why are we investing here? Think of it this way: the government is making bridge loans to major banks and non-bank financials. If you invest in high-quality corporate issuances of those companies, which are senior to the government’s investments in preferreds, the government would have to lose all its TARP money before you would lose your money. And we do not believe the government will sit by and watch their investments disappear. Consequently, these companies will likely get continued support from policy makers.

We expect rising interest in investment-grade corporates
We have a cautious view on the economy, but spreads on investment-grade corporate bonds are so wide that they are attractive—particularly relative to other fixed-income opportunities. We believe that Treasury yields are too low, that high-yield bonds are too risky and that equities are too risky—particularly given the fact that you may be able to earn 7% or more with what we believe are high-quality corporate bonds at the top of the capital structure.

As a result, we expect two things to happen:
- Conservative investors will move out of traditional Treasuries and agencies into these high-quality corporate bonds, and that will be a main inflow to the asset class.
- Investors in more risky areas, like equities and even high yield, will begin to pursue high-single-digit returns in investment-grade corporates.

With this movement, we expect to see some modest spread tightening that would drive up prices of investment-grade corporate bonds, which is why we believe we could see total returns of 8%, 9% or even 10% return in this asset class.

In summary, we think investment-grade corporate bonds make sense today. We certainly are not optimistic on the economy, but we also believe that the government’s policy is pedal to the metal, and the valuations on this asset class look compelling particularly given their seniority in the capital structure.

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Glossary

- Corporate Bonds: As rated by Moody's, S&P and other ratings agencies, investment-grade bonds can be high-quality (AAA, AA, etc.), as well as medium quality (A, BBB, etc.). High-yield (or "junk") bonds are considered below-investment grade, and are rated BB, B, CCC, etc.
- Price and Yield: The prices and yields of bonds move in opposite directions on the open market. A bond's yield is calculated by dividing its coupon rate (the income stated by the bond's issuer) by its price (which, according to the open market's laws of supply and demand, can move above or below the bond's original par value). If a bond's price moves lower, its yield moves higher; if its price moves higher, its yield moves lower. It is possible to buy a bond at a discount (when its price is below its initial par value) and sell it later when its price appreciates; this would increase your investment's total return (income plus price appreciation).

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