

TIPS at a Tipping Point

11/18/08-Mihir Worah and Bob Greer of PIMCO discuss the recent underperformance of TIPS and why they believe the outlook is attractive for this asset class going forward.



Mihir Worah
Executive Vice President
PIMCO



Bob Greer
Executive Vice President
PIMCO

TIPS underperformed in recent months

In the last two months Treasury Inflation-Protected Securities (TIPS) have suffered steep price declines compared to nominal Treasuries. This year, through August, Barclays Capital U.S. TIPS Index was positive. But it declined by 3.83% in September, and a further 8.69% in October. This negative return is not limited to U.S. TIPS. Barclays Capital Global Inflation-Linked Bond Index, for instance, declined by 3.23% in September, and a further 6.63% in October.

For comparison, the Barclays Capital U.S. Treasury Index returned 0.61% in September and -0.11% in October. Real yields on 10-year TIPS on November 13 were 2.91%, compared to a nominal yield of 3.76% on the 10-year Treasury. The difference in these two rates, called "breakeven inflation (BEI)," is the rate of inflation that would have to occur over the next 10 years for these two bonds to provide the same total return. That BEI was a very low 0.85%.

Why TIPS suffered more than nominal Treasuries

October was the single worst month for TIPS since they were first issued in January 1997. There were a couple of factors causing this. The major fundamental factor was reduced inflation expectations leading to reduced demand for inflation protection. Another factor was a flight to quality and to liquidity.

It's no secret that financial markets are going through a global "delevering." Risky assets are being sold—by choice or because the sale is forced. To the extent that sale proceeds are being reinvested, they are

going to markets that not only are less risky (a flight to quality), but also more liquid (a flight to liquidity). And nominal Treasuries are much more liquid than TIPS.

This delevering accompanied a developing global recession, and expectations of that recession led the markets to expect a reduced demand for goods and services. This in turn is causing lower commodity prices, which has caused us to expect lower inflation. If you are expecting lower inflation, you have less need for TIPS and more desire for the greater liquidity of nominals.

The other important factor that has affected TIPS markets is that some hedge funds, especially equity hedge funds, bought TIPS as a substitute for buying crude oil futures. That's because there has been an increasing correlation between these two assets. Now many of those hedge funds are delevering, and also expectations for crude oil prices have been lowered. So as this trade has been unwound, it has caused additional selling of TIPS.

Near-term outlook for lower inflation

Our expectation is that inflation, the U.S. CPI, will come down over the next year. Headline inflation has been pumped up by food and energy prices, so that the latest numbers, released in mid-August, showed a year-on-year inflation of 4.9%, compared to 5.4% year-on-year reported a month ago. So inflation is starting to decline already. The decreases we have seen in energy prices will work their way through the rest of the CPI, for the most part, over the next few months. Decreases in grain prices take close to a year to be fully realized in the food component of the CPI, so the grain price declines we have experienced since summer will continue to exert downward

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surprising to see headline inflation at some point in 2009 below 1%, and the non-seasonally adjusted CPI might even briefly be negative.

Inflation should increase over secular time frame

Beyond the current severe economic weakness and drop in commodity prices, however, we are sowing the seeds for renewed inflation over our secular time frame. As Bill Gross said in his October *Investment Outlook*, “Expect a lengthy recession, but not a depression, accelerating government deficits ... and the eventual rise of inflation.” The drivers of renewed inflation include:

- Central banks providing liquidity, which is currently not making its way into the broader economy, though that is the goal and will be the eventual result. These banks explicitly want to reflate our economies.
- Currently, central banks can raise money by issuing Treasuries, since that is what investors want. But if that ends, then the Treasury may simply have to turn on the printing presses.
- The drop in commodity prices is causing producers to delay plans for the expansion of supply that will be needed as the global economy recovers. This creates the potential for the kind of imbalance of demand over supply that we saw from 2006 through the first half of 2008.

So we expect inflation to moderate over the near term, but to be a renewed and potentially even more serious problem over the secular time frame. What does this say about TIPS valuations?

1. Relative to nominal Treasuries, we believe TIPS currently represent better value. Specifically, given our longer term view of inflationary pressures, we favor longer-dated TIPS. We don't expect inflation to be as low as implied by the current breakevens. Those BEIs, we believe, are driven more by technical factors than by a radical change in inflation outlook.
2. On an absolute basis, real yields of about 3% are attractive given the low level of credit risk in holding TIPS. Over a long period of time, nominal Treasuries have seldom offered yields that, in real terms, were above 3%. And in the 11 1/2-year history of TIPS, that level of real yields was seen up to 2000 and seldom since.

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pressure on the CPI well into next year. It would not be

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Strategies currently used in TIPS portfolios

Our strategies can best be described as maintaining liquidity, holding many of our non-TIPS views while not adding to those positions, and taking advantage of the mispricing of TIPS due to technical factors. We have recently moved from an underweight TIPS duration to an overweight TIPS duration, with an emphasis on longer maturity TIPS. Beyond those themes, our portfolios are staying pretty close to their benchmarks in currency exposure and other risk measures. While these allocations may have detracted somewhat from relative performance recently, we nonetheless expect these allocations to begin to add value as markets start to normalize.

PIMCO Real Return Fund performance

Over the longer term, TIPS have provided value to our portfolios. And over the longer term, say three or five years, the A Shares of the PIMCO Real Return Fund have come close to the index after fees. But recently, as TIPS declined in value, so did our performance relative to the index.

The main reason for this performance was that we took positions in non-TIPS sectors when we thought they represented great value. This was most obvious in our purchases of debt issued by financial institutions, and also our purchases of agency-backed mortgages. As you have heard Bill Gross and others say, while we still like much of that paper, we were early in our purchases, and many of those assets have been written down on a mark-to-market basis.

Investors should consider the investment objectives, risks, charges and expenses of this Fund carefully before investing. This and other information are contained in the Fund's prospectus, which may be obtained by contacting your financial advisor, by visiting www.allianzinvestors.com or by calling 1-888-877-4626. Please read this prospectus carefully before you invest or send money.

Past performance is no guarantee of future results and current and future portfolio holdings are subject to risk. U.S. government bonds, TIPS and Treasury bills are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and fixed principal value.

The PIMCO Real Return Fund invests in inflation-indexed bonds of varying maturities. It may invest in non-U.S. securities. The Fund may also invest in mortgage-related securities as well as a portion in high-yield securities. Inflation-indexed bonds issued by the U.S. government, known as TIPS, are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation, which will affect the interest payable on them. Repayment upon maturity of the adjusted principal value is guaranteed by the U.S. government. Neither the current market value of inflation-indexed bonds nor the share value of a fund that invests in them is guaranteed, and either or both may fluctuate. Investing in non-U.S. securities may entail risk due to foreign economic and political developments; this risk may be enhanced when investing in emerging markets. High-yield bonds typically have a lower credit rating than other bonds. Lower rated bonds generally involve a greater risk to principal than higher rated bonds. Mortgage-backed securities are subject to prepayment risk. The value of some mortgage-related or asset-backed securities may be particularly sensitive to interest rate changes, and there is no assurance that private insurers of the underlying mortgages or assets will meet their obligations. When interest rates rise, the value of fixed-income securities generally declines. This Fund may use derivative instruments for hedging purposes or as part of its investment strategy. Use of these instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a fund could not close out a position when it would be most advantageous to do so. Portfolios investing in derivatives could lose more than the principal amount invested in those instruments. This Fund is non-diversified, which means that it may concentrate its assets in a smaller number of issuers than a diversified fund.

*Cadence Capital Management is an independently owned investment firm.

The Barclays Capital (BC) U.S. TIPS Index is an unmanaged index comprised of all U.S. Treasury Inflation Protected Securities rated investment grade (Baa3 or better), have at least one year to final maturity and at least \$250 million per amount outstanding. The BC U.S. Treasury Index is a component of the U.S. Government Index, consisting of U.S. Treasury securities with a remaining maturity of one year or more. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. It is not possible to invest directly in indexes.

Core CPI is an inflationary indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity and transportation. Core CPI differs from the wider know CPI in that it excludes the volatile food and energy. Since food and energy prices are volatile, the "core CPI" is thought to be a more accurate measure of underlying inflation.

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