PIMCO U.S. Credit Perspectives

Mark Kiesel
PIMCO
Managing Director,
Portfolio Manager

Rising Tide to Choppy Waters

Q: About six months ago you became more bullish on credit than you have been in years. How has the market performed since then, and what do you expect in the second half of the year?

Kiesel: Six months ago we believed that credit spreads, at their widest levels in more than 20 years, were overstating default and liquidity risk and offered extremely attractive risk-adjusted returns. Our December 2008 *U.S. Credit Perspectives,* "Credit Now, Equities Later," argued the credit market provided investors the opportunity for equity-like returns with significantly less risk than equities. Since then, the market has snapped back aggressively and credit spreads have tightened considerably (Chart 1). Credit significantly outperformed equity in the first half of 2009 with high yield up +25.5%, investment grade credit up +6.9% and equities (the S&P 500) up +3.2%,[1] and credit outperformed with lower volatility relative to equities.

Fueled by strong demand for high-quality credit and a rising tide that lifted all boats, almost all sectors of the corporate bond market demonstrated strong returns in the first half of the year. So in the first half of 2009, it was about being long credit risk.

We still believe there is significant opportunity in high-quality investment grade corporate bonds; however, we think that potential headwinds—in the form of weak economic fundamentals—lurk in the waters ahead for certain sectors and companies. Successfully navigating this environment will require extensive top-down macro and bottom-up credit research in order to identify the companies and sectors which have the potential to run aground or capsize. Investors need to closely evaluate each company's debt maturity profile, revenue outlook and free cash flow generation in order to sail through some potentially rough seas that will result from ongoing deleveraging, particularly by consumers.

Going forward, it's going to be even more important to identify not just which sectors are going to fare best in a tough economic environment, but also which companies are fundamentally healthy enough to sail through choppy waters unscathed. Differentiation is increasingly the name of the game. Investing in credit is going to be more challenging in the second half of the year than it was in the first half. A quality bias and being highly selective shouldbe rewarded.

Q: How does the PIMCO investment process facilitate the kind of exacting analysis necessary in these markets?

Kiesel: At PIMCO, we apply both top-down macroeconomic views and bottom-up company- and market-specific analysis of each security that goes into our client portfolios. We manage both our investment grade corporate bond and high yield portfolios based on our top-down secular views. To use the sailing analogy, our top-down views serve as the compass in our investment process. The global economic themes that we develop during our secular

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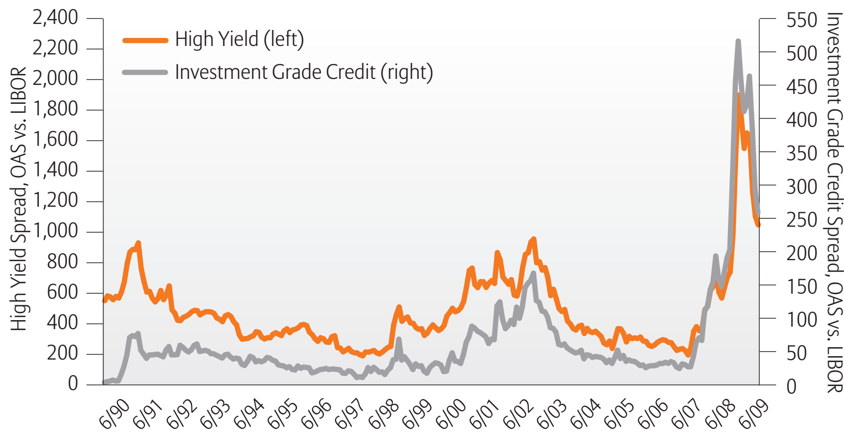
Chart 1 | Credit Spreads Significantly Tighter In 2009



Source: Merrill Lynch (U.S. High Yield Cash Pay Index) and Barclay's (Investment Grade Credit Index).

and cyclical forums are particularly important in determining which sectors we will overweight and which we will underweight. Then we build the portfolio from the bottom up based on our credit analysts' views on individual companies in our preferred sectors as well as our portfolio managers' relative value assessment of specific securities within our favored companies.

One of the dominant themes that came out of our most recent secular forum is our expectation that emerging market economies, led by China, will continue to outperform developed economies such as the U.S., Europe and Japan—albeit in the context of subdued global growth overall. China has both the will and the wallet to sustain higher economic growth rates, and we expect expanded government spending to build infrastructure to bolster employment and maintain political stability.

Another element of our secular view is that commodities and energy will be some of the main beneficiaries of the aggressive fiscal and monetary stimulus. Such policy response is likely to result in negative real interest rates around the world, supporting a move into hard assets. This has caused us to turn more bullish on low-cost energy and metals producers, in particular.

There are also sectors that benefit directly from government stimulus and support programs—especially the banking sector.

On the other hand, another theme that emerged at our forum is that headwinds from deleveraging in the global economy will continue. This is a secular process in which credit creation will be constrained at both the corporate and the consumer level. In particular, consumer deleveraging is far from complete in the U.S. and U.K., and we expect industries such as retailing, home building, gaming, lodging and companies exposed to commercial real estate to be especially vulnerable. In this environment, we prefer industries that have low levels of leverage and hard assets, such as utilities and pipelines. Not only do we expect low default rates in these sectors, but in the event of default, strong asset coverage also leads to higher expected recovery rates.

Once we refine our strategy from the top-down perspective, we look at the bottom-up dynamics of the industries and companies. For instance, we look closely at the supply and demand dynamics influencing the top-line growth prospects for an industry or company. Naturally, we like industries in which demand is rising relative to supply, with room for expansion and free cash flow generation, which can be used to pay down debt. As bondholders, we favor stability and diversity in the sources of revenue coupled with prudent capital structure management. At the most basic level, we're looking for companies with strong leadership and credit fundamentals that are stable or improving.

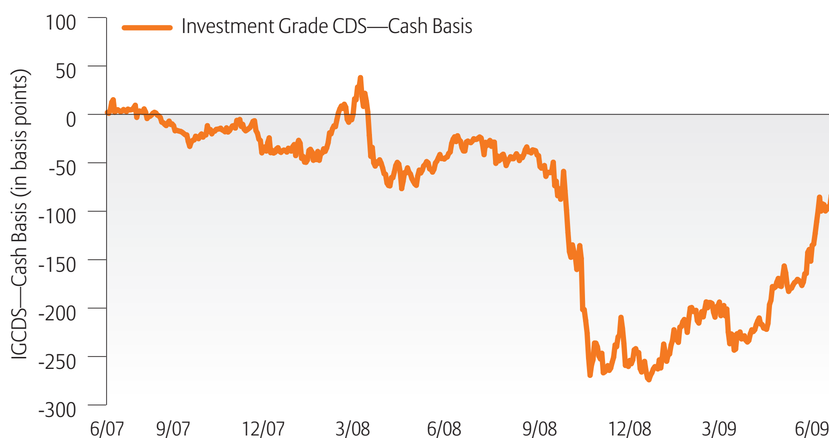
Q: With the rally in credit spreads, the market is now pricing in lower expected default rates than earlier this year. Is that a sign that we are coming into a safe harbor?

Kiesel: Just because we've seen a sharp tightening in credit spreads and a rally in the equity market does not mean that the economy is in calm waters. When considering current valuations in credit markets, we always look closely at both fundamental and technical (i.e., supply/demand) factors. A certain amount of the year-to-date spread tightening has been technically driven, the result of strong demand for credit, improved liquidity in financial markets and reduced systemic risk.

One way to track liquidity in credit markets is in the relationship between the spreads for cash (physical) bonds and credit derivatives. This relationship is known as the "basis" in credit markets, and historically spreads in both markets have traded very closely to one another. However, this relationship became highly dislocated as cash bond markets became extremely illiquid in the fourth quarter of 2008. That is to say, as credit spreads reached all-time wide levels at the end of last year, a sizeable amount of the spread could be attributed to liquidity premiums.

As liquidity in financial markets has recently improved, spreads for cash bonds have tightened more dramatically than those in the derivative markets (Chart 2). Like a rising tide lifting all boats in a harbor, improved liquidity conditions helped to provide strong returns for the broad credit markets in the first half of the year.

Chart 2 | Cash Has Outperformed CDS by 170 Basis Points So Far in 2009



Source: JPMorgan (basis is CDS spread minus cash bond LIBOR spread).

While credit spreads have benefited from reduced systemic risk and a strong technical environment, we remain cautious on the fundamentals of certain sectors of the credit markets. As the banking system deleverages and moves toward a more conservative utility-like model, there will be less credit circulating through the economy. This lower level of credit extension could lead to elevated levels of defaults.

We believe the government's support programs and the recent ability of some companies to raise equity capital has most likely delayed the default cycle, but it has not eliminated it. Thus, given the recent narrower spreads due to the significant year-to-date tightening, we are taking a more conservative approach in our portfolios. We are still anticipating a weak economic recovery given softness in the labor market, where 6.5 million jobs have been lost in the U.S. over the past 18 months,[2] and very tight credit standards to individuals. Given these economic fundamentals, we think it makes sense to reduce risk given how quickly credit markets have rallied.

We also believe that refinancing risk—which affects companies' ability to replace maturing debt—has been pushed into the future by policy stimulus, though not eliminated. Credit fundamentals are still going to be challenging, especially for companies with significant leverage. It is important to note that for every security that Moody's upgraded this year, they have downgraded seven.[3]

In addition to a potential rise in default rates, we expect lower recovery rates for unsecured bondholders given high leverage, weak economic growth and high levels of senior secured debt in the capital structure of many high yield companies. The recovery rate so far this year has been about 20% based on 76 high yield companies that defaulted.[4] Meanwhile, high yield remains a risky bet. Today's 11% default rate for high yield issuers is over 27 times the 0.4% default rate for investment grade issuers.[5] In fact, the more striking number is the dollar-weighted (rather than issuer-weighted) default rate in high yield, which is 18.2% after the GM bankruptcy. 5 Since high yield spreads have already narrowed by over 800 basis points this year,6 we think more caution is warranted in high yield.

Q: So you're cautious, but there are still industries you think are better positioned to withstand this secular storm?

Kiesel: Yes. We still like pipelines and we still like utilities; we think it's very good to own debt from these industries going into an environment where it will be difficult for many companies to have access to funding.

Several key positives for the pipeline sector are that the industry has consistent access to the equity and debt markets, is relatively unleveraged and has stable, fee-based, non-cyclical cash flows. Many pipeline companies have leverage ratios (Debt/EBITDA) of only three to three-and-one-half times, and they operate with long-term contracts. Additionally, these companies typically tap the equity market to fund capital expenditures. Very importantly, these companies are growing organically. They throw off free cash flow and when they need expansionary capex, they typically do so in a disciplined manner by raising equity capital.

Access to equity and debt capital is going to be a key distinguishing feature in the second half of 2009, and we will continue to watch the equity market for signals. A leading indicator of a company's ability to endure the recession is its ability to raise money in the equity and unsecured bond markets.

The utilities sector has also been a strong performer, and we think we will see more outperformance in the second half. There rarely is a loss of principle on utility sector first mortgage bonds. Broadly speaking, utility companies have hard assets and tend to recover at a much higher level than companies that don't have such strong tangible assets, such as technology or retail companies. Utilities are also naturally defensive because demand for their services is less driven by strength or weakness in the economy.

Q: What about financial services companies?

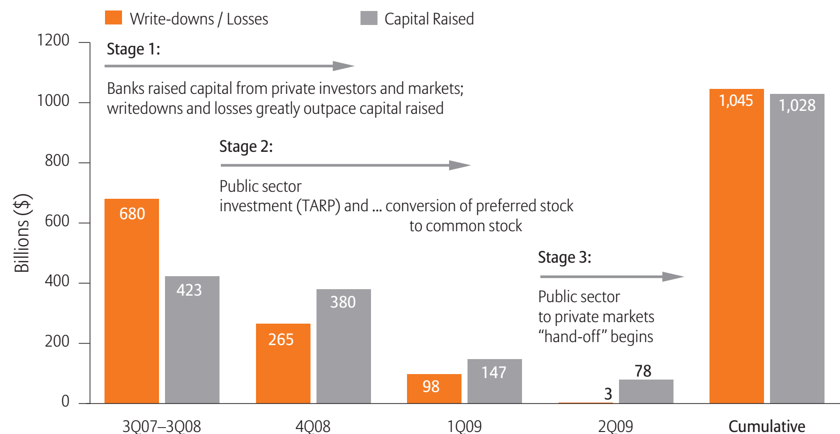
Kiesel: The banking system is unique, but like other sectors, it takes exhaustive research to determine which banks will stay afloat and which ones could sink.

There are some banks we don't like because we see them as vulnerable to sub-par economic growth, weak consumer spending and declining commercial and residential real estate markets. Consumer and business loans will continue to be under pressure with a weak economy. As such, thorough bottom-up credit analysis will be needed to navigate today's waters.

But we do like a handful of global "national champion financial firms," which are relatively diversified, have global deposit bases, relatively healthy balance sheets, access to government and central bank support and are benefitting the most from steep yield curves. In the U.S., the FDIC's Temporary Liquidity Guarantee Program (TLGP) has reduced default and liquidity risk for the companies that participate in that program. And obviously the Troubled Asset Relief Program (TARP) was used largely to directly recapitalize important financial institutions. We view a select group of national champion financials as the equivalent of supertankers that have the support necessary to weather potential economic and financial storms.

For the banks, the first half of 2009 has really been a tale of two very different quarters. In the first quarter we were waiting for the results of the stress tests and had to deal with uncertainty surrounding the conversion of preferred stock to common stock. There was a tremendous amount of uncertainty that led to deterioration and underperformance of banks, particularly in the lower parts of the capital structure.

Chart 3 | Stages of Bank Recapitalization

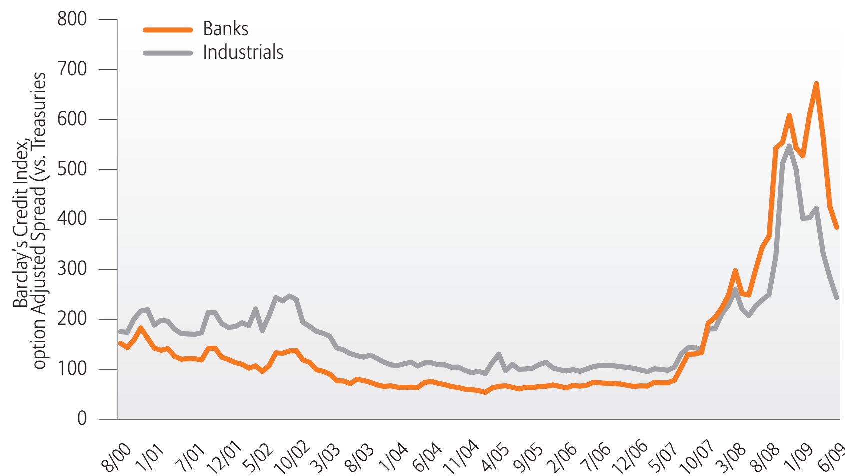


Source: Bloomberg.

In the second quarter we saw the results of the banking stress tests. The government announced the amount of capital they wanted the banks to raise, and they proceeded to do so, primarily in the equity market. It was also significant to see that some banks were able to tap into the unsecured corporate bond market. Now, some of those companies have successfully sold assets, and some of the stronger ones are already able to repay some of the TARP funds. The beginning of a successful "hand-off" from the public sector to the private capital markets marked a key transition and stage for bank recapitalization (Chart 3).

Going forward, we believe certain bonds should outperform as the industry continues to transform from a growth business to more of a utility business. In the process it is going to become less risky, with less leveraged balance sheets: That's good for bondholders (although maybe not as good for equity holders).

Chart 4 | Bank Spreads Wide vs. Industrial Spreads



Source: Barclay's.

We think the current yields on bank debt—senior bank debt is roughly 5% to 7%, subordinated debt is 7% to 8%, and some of the Tier 1s are still yielding 9% to 13%—represent considerable value for certain names.

We think select banks look cheap relative to other asset classes such as high yield, as well as other sectors of the investment grade corporate bond market. As an example, banks still trade wide to industrials (Chart 4).

Q: Are there other sectors that you also think are attractive in the current environment?

Kiesel: We think some subsectors of healthcare make sense, including branded and generic pharmaceutical companies, hospitals, hip and knee replacement companies and dialysis companies. Most of these companies generate the bulk of their revenue from non-discretionary spending. In addition, most of them own tangible assets and will benefit from secular growth dynamics.

We also believe that telecom and cable companies will be relatively stable in an environment of sub-trend economic growth. These are companies that have relatively high margins and low leverage, along with pricing power and fairly stable operating performance.

Finally worth noting is the increased volume of taxable municipal bond issuance, much of which is a result of the government's "Build America Bonds" program. We find certain of the taxable municipal issues to be attractively priced when compared to corporates of similar credit ratings.

Q: Which sectors you are staying away from?

Kiesel: We're now avoiding some of the sectors that rallied the most in the first half of this year. This was a high beta rally, and we think the rising tide has lifted some boats too much. We are entering waters that will differentiate winners from losers, and company fundamentals are going to be vitally important. We think that some of the companies currently trading at very tight spreads have rallied too far—that is to say, there are instances where the market is pricing in an ice cube in front of the boat and yet we see the tip of an iceberg. This is particularly the case for certain high yield credits.

We think that some retailers, homebuilders, gaming and lodging companies, refiners and companies exposed to commercial or residential real estate will be facing severe headwinds in the second half, and some of these ships may not stay afloat. Most of the credits that run aground or sink are going to be the more highly leveraged high yield companies that face refinancing concerns going forward.

Meanwhile, although technical supply and demand factors have been supportive for both the investment grade and high yield markets recently, they will likely remain more supportive for higher-quality issues going forward. In general, we think it's a good time to upgrade credit quality, and that's our strategy for the second half.

Q: Is your strategy similiar in investment grade and high yield given your outlook for choppy waters?

Kiesel: Whether we are looking at investment grade or high yield, we are planning to emphasize very similar top-down themes. We're overweight companies that benefit from policy support as well as companies with hard assets, relatively stable and low operating costs and less leverage. We're underweight a lot of companies that are susceptible to U.S. consumer spending as well as companies that have higher levels of leverage.

As financial markets seek to heal themselves from the tsunami of the past two years, company-specific fundamentals will become increasingly important. In this environment, successful investing in credit markets will be driven by thorough bottom-up research in the context of a strong understanding of macroeconomic conditions and public policy initiatives. Now that the tide has risen, it's time to grab the wheel with a steady hand, for the choppy waters ahead present attractive investment opportunities if navigated carefully.

About the Author:

Mark Kiesel is a managing director in the Newport Beach office, a generalist portfolio manager, global head of the corporate bond portfolio management group and a senior member of the investment strategy and portfolio management group. In his role as global head of corporate bond portfolio management, he oversees the firm's investment grade credit, high yield and bank loan business. He also manages corporate and equity portfolios for the firm. He joined PIMCO in 1996 and previously served as PIMCO's head of equity derivatives and as a senior credit analyst. He has 15 years of investment experience and holds an MBA from the University of Chicago Graduate School of Business. He received his undergraduate degree from the University of Michigan.

1. Merrill Lynch (U.S. High Yield Cash Pay Index) and Barclay's (investment grade credit index), total return, 12/31/2008 through 6/30/2009
2. Bureau of Labor Statistics, Nonfarm Payrolls, total change from June 2009 to December 2007
3. Moody's, through June 30, 2009
4. JPMorgan, through June 30, 2009
5. Moody's, June Default Report, published July 8, 2009
6. Merrill Lynch, BB/B index, through June 30, 2009

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