

Questions
& Answers

Investment Outlook 2012

by Horacio A. Valeiras, CFA, and Greg A. Meier

Wall Street may be content to close the books on 2011. With Japan's devastating earthquake, revolution in the Middle East, the U.S. credit downgrade and Europe's interminable debt crisis, it was a year of white-knuckled volatility. Despite record earnings and rising revenues, corporate fundamentals frequently took a backseat to global macroeconomic fears. What will 2012 bring? At the start of the year, while stock prices were increasing, so was the threat of a sovereign default in Europe. It is unlikely both trends can be sustained for long. With nearly a quarter century of global securities markets expertise, Chief Investment Officer Horacio A. Valeiras, CFA, shares his perspective on risks and opportunities in the year ahead.

Let's begin with the European debt crisis. It has cast a shadow over markets for more than two years. Is the outlook any brighter for 2012?

Political brinkmanship allowed the crisis to spread into Europe's solvent core. This didn't need to happen; policymakers could have prevented contagion by acting more decisively. The longer they wait, the worse the fallout will be. Stock and bond investors seem to understand the risks involved, while politicians act like they just don't get it. Markets may precipitate resolution to the crisis in 2012, perhaps sooner rather than later. I would watch credit rating actions, default swap spreads

and ten-year bond yields for Italy and Spain. Italy expects to sell €440 billion in debt in 2012, much of it in the first few months. Access to markets will be critical and yields above 7% tough to sustain. Market instability and political dithering should give way to a conclusive solution from the European Central Bank.

The alternate option is grim. Conditions were deteriorating across Europe entering 2012. Germany, Europe's largest and strongest economy, was on negative credit watch. A disorderly break-up of the currency union is a possibility with global implications. The time for half-measures is ending. Pressure to remedy the situation will be high.



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Assuming the crisis is defused, what is the economic outlook for Europe?

Europe appears to be heading into 2012 in recession. Combined with sovereign uncertainties, bank deleveraging and government austerity, this should prevent an annual expansion in euro area GDP in 2012. Italy, Portugal and Greece should contract. The threat of a liquidity crunch may ease as the year progresses, but Europe is going to remain a drag on global growth.

Do you think that a more disciplined European Union policy on deficit spending is a long-term positive or negative for growth?

Lack of fiscal discipline is at the heart of Europe's sovereign crisis. Spending cuts may cause short-term pain, but eventually, in one form or another, government obligations are going to get resolved. The turn toward fiscal prudence should bring long-term economic benefits.

Europe's problems may have some foretelling for the U.S. if Washington's deficit is not addressed. The U.S. government has promised its citizens more than what can be covered through higher taxes.

Political gridlock devolved into the first-ever downgrade for U.S. sovereign debt in 2011. What can investors expect from U.S. politics this year?

It is pretty unlikely 2012 will be a breakthrough year in Washington. Partisanship over the debt, spending, regulation and the role of government will continue. At times, it might spook investors. Fiscal tightening shouldn't have a large near-term impact because spending cuts have been back-end loaded.

Depending on the outcome of the 2012 elections, we will see whether we move into a period of higher taxes or reduced spending. In our view, a reduced government role will be better for equities and higher taxation will be better for bonds. Markets should begin to price the new environment during the run-up to the November elections.

The U.S. economy was picking up speed as 2011 came to a close. What are the chances this can be sustained into 2012?

Our stance on the U.S. is unchanged—we are in the middle of an anemic multi-year expansionary cycle. As long as conditions in Europe don't deteriorate significantly, for 2012, we expect sub-par 1.5-2% growth and no double-dip recession. Business fundamentals are strong, but deleveraging and economic and political uncertainty will keep a lid on hiring and wages. Real estate investment may contribute to GDP growth in 2012, but a strong housing recovery depends on sustained improvements in foreclosures and unemployment, which will take time. Deleveraging the world's developed economies will be a long-term process, which means sluggish growth for the foreseeable future.

Global monetary policy is now directionally aligned. Do you expect this to continue in 2012? What are your thoughts about the prospects for acceleration in inflation?

Many countries should experience a technical slowdown in inflation early in 2012 based on the combined effects of tougher year-over-year comparables and decelerating global growth. This will provide scope for central bankers to ease policy further. Past rounds did little to spur growth, but as the year progresses, the Bank of England and the U.S. Federal Reserve may feel compelled to launch new rounds of quantitative easing.

As long as the euro crisis is resolved, disinflationary pressures should prove temporary, particularly for emerging markets. Continued, exceptionally loose monetary policy in the U.S., the U.K. and Europe raises the threat of higher, longer-term inflation. Policy easing in the emerging world in 2012 will accelerate this problem.

What else should investors expect from emerging markets in 2012?

Last year's synchronized sell-off in global equities doesn't reflect the fundamental divergence we see in economic prospects. While the developed world is looking at an extended period of weakness, emerging economies are faced with a mild slowdown in 2012, with growth of about 6%. Rising domestic demand and infrastructure spending should partially offset weaker exports to developed countries and tighter global banking standards. Policy easing will encourage consumer spending and investment. We expect more than two thirds of global growth to come from emerging markets this year.

Sovereign credit ratings provide a view into a country's economic health. Since the start of the financial crisis, downgrades have been centered in the developed world and upgrades have been focused among developing countries (see Figure 1). While industrialized economies struggle to delever, emerging markets have grown stronger. The rise of the industrializing world is a multi-year process that is transforming the global economy.

What are your thoughts on growth in China and the potential for a property bubble there?

People have been forecasting a hard landing in China for years. I wouldn't expect it anytime soon. Stability is too important for the Communist Party, which still retains control over social and economic levers, including banking and investment. The five-year party congress should take place toward the end of 2012, and it is unlikely the transfer of power to a new generation of leaders will coincide with any major policy changes.

Figure 1: The Post-Crisis Credit World

Since 2007, negative credit actions have been focused among developed countries, while credit rating and outlook upgrades have been centered in the developing world. Pressure on developed countries should continue, given high debt levels, high unemployment and weak economic prospects.

Developed Markets

	January 3, 2007		December 29, 2011	
	Rating	Outlook	Rating	Outlook
Germany	AAA	Stable	AAA	Negative
France	AAA	Stable	AAA	Negative
Netherlands	AAA	Stable	AAA	Negative
Finland	AAA	Stable	AAA	Negative
Austria	AAA	Stable	AAA	Negative
Luxembourg	AAA	Stable	AAA	Negative
United States	AAA	Stable	AA+	Negative
Belgium	AA+	Stable	AA	Negative
New Zealand	AA+	Stable	AA	Stable
Spain	AAA	Stable	AA-	Negative
Japan	AA-	Positive	AA-	Negative
Italy	A+	Stable	A	Negative
Ireland	AAA	Stable	BBB+	Negative
Portugal	AA-	Stable	BBB-	Negative
Greece	A	Stable	CC	Negative

Emerging Markets

	January 3, 2007		December 29, 2011	
	Rating	Outlook	Rating	Outlook
China	A	Stable	AA-	Stable
Taiwan	AA-	Negative	AA-	Stable
Czech Republic	A-	Positive	AA-	Stable
Chile	A	Positive	A+	Positive
Poland	BBB+	Stable	A-	Stable
Brazil	BB	Positive	BBB	Stable
India	BB+	Positive	BBB-	Stable
Colombia	BB	Positive	BBB-	Stable
Peru	BB+	Stable	BBB	Stable
Indonesia	BB-	Stable	BB+	Positive
Philippines	BB-	Stable	BB+	Positive
Turkey	BB-	Stable	BB	Positive
Paraguay	B-	Positive	BB-	Stable
Bolivia	B-	Negative	B+	Positive
Ecuador	CCC+	Stable	B-	Positive

Source: Standard & Poor's; Allianz Global Investors Capital; see additional disclosure; as of December 29, 2011

We expect China will grow 8-9% in 2012. That is slower than past years, but China's economic outlook is healthier than any major developed country (see Figure 2). There is a real estate bubble, but the government can still manage it.

What are your thoughts on U.S. equities, volatility and valuations? Is there a disconnect between macro concerns and corporate fundamentals?

I expect volatility and correlations to remain high until Europe's debt crisis is addressed and further progress has been made on the road to deleveraging. However, a substantial amount of risk has already been priced into equities. The S&P 500 is trading at 11.3x 2012 earnings—

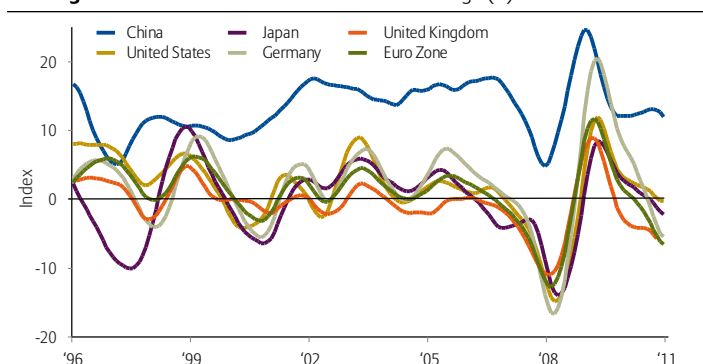
more than 20% cheaper than the long-term average. The bottom-up consensus forecast for 2012 earnings growth is just under 10%—a rate we think is achievable (see Figure 3). As resolution to the euro crisis comes into focus, attention will return to corporate fundamentals, which are healthy.

We note that concerns over the euro crisis have been ongoing for more than two years. Debate over Washington's borrowing limit began in earnest in March 2011 and culminated in the loss of America's AAA rating last August. Within a very challenging environment, S&P 500 profits, margins and cash levels are at or near all-time highs and overall sales continue to increase.

Figure 2: Global Economic Prospects

Economic conditions were weakening entering 2012. Europe probably started the year in recession, as core countries succumbed to the debt crisis. China looks poised for a so-called 'soft landing'. Post-earthquake reconstruction should support Japanese growth.

Leading Economic Indicators 12-month rate of change (%)

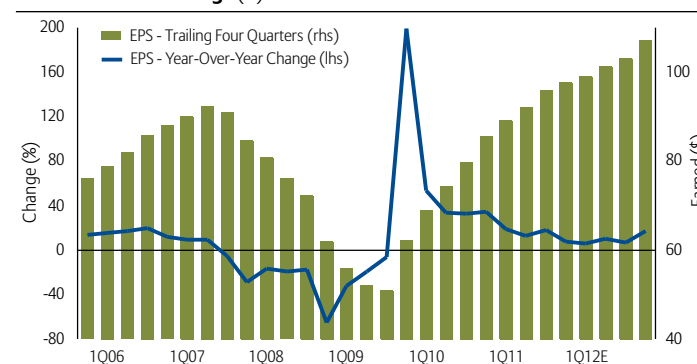


Source: Organisation for Economic Co-operation and Development; Allianz Global Investors Capital; see additional disclosure. U.K. as of September 30, 2011; all other countries as of November 30, 2011

Figure 3: Profit Growth

Bottom-up projections for corporate earnings held up well in the face of global macro concerns last year. Consensus forecasts indicate 10% year-over-year growth in 2012, a rate we think should be achievable.

S&P 500 Index Earnings (%)



Source: Thomson Reuters; Standard and Poor's; Allianz Global Investors Capital; see additional disclosure; as of January 6, 2012

Where are you seeing the best opportunities for investment? Entering 2012, would you overweight any sectors or asset classes?

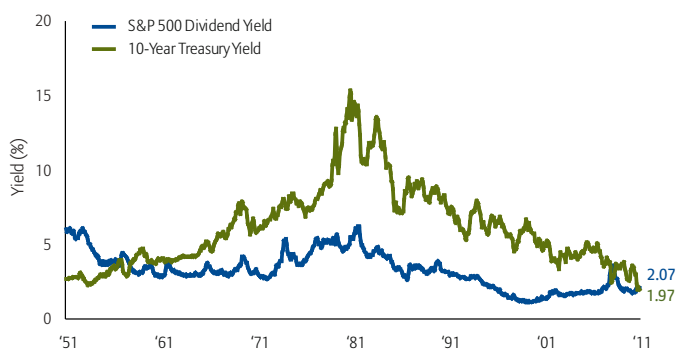
For 2012, we particularly like dividend-paying stocks and cash-flow-generating companies that can pass through price increases. Dividend payers tend to be less volatile than the overall market and there is additional scope for payouts to grow. S&P 500 companies have more than \$1 trillion in cash on hand, but they are distributing a record low percent of income as dividends. With ten-year Treasury yields below 2% and baby boomer retirees in need of income, dividend stocks remain one of our top picks (see Figure 4).

We also like real assets and high yield bonds. Current high yield spreads do not reflect the strength of the average issuer's balance sheet. Default rates are low and we expect they will remain low for an extended period. High yield bonds can offer equity-like returns with reduced volatility and exposure to healthy corporations instead of indebted governments.

Figure 4: Dividend Investing

At the close of 2011, the S&P 500 Index offered a better yield than U.S. Treasuries. With corporate cash levels at record highs, dividend tax rates low and government bonds an uncertain bet, dividend-paying stocks should continue to do well.

Dividend Investing



Source: Robert Shiller; Standard and Poor's; Allianz Global Investors Capital; see additional disclosure; as of December 30, 2011

From a global standpoint, if the euro crisis doesn't implode, European exporters should benefit from a currency weakened by sovereign concerns and recession.

What concerns you most as you look to the next few years?

We believe policy missteps and inflation are the most important longer-term threats facing investors. With governments' hands tied by debt and austerity, there will be increased pressure for monetary authorities to take action. Larger swings in the economic cycle and increasing longer-term inflation are likely outcomes. The probability of these things happening in the near-term is low.

Would you like to conclude with 2012 year-end forecasts on U.S. unemployment, the S&P 500, currency valuations and/or the price of oil?

I expect joblessness in the U.S. will moderate only slightly to 8.4% by the end of 2012. Improvements will be based more on workers exiting the labor market than robust hiring. For equities, volatility will continue and, as a central forecast, I expect the S&P 500 could rise 5-10%. However, if the European debt crisis is decisively addressed, shares could go much higher; a 15-20% rally is feasible. It isn't our base-case, but if the euro area were to fragment, I would expect significant losses across risk assets.

The U.S. dollar should weaken versus emerging market currencies and gain modestly versus the euro, less versus the yen. Oil should strengthen to \$105/bbl, significantly more if tensions with Iran escalate. As long as the euro crisis is outstanding, volatility, correlations and upside and downside risks will be high.

Horacio, thank you for sharing your insights.

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