

Market Environment and Outlook: First Quarter 2012

The Market Environment and Outlook of Horacio A. Valeiras, CFA, Chief Investment Officer



ECONOMIC ENVIRONMENT – Is the economy finally on a self-sustaining path?

Recent economic reports point to a healthier growth environment in the U.S. within the context of the anemic long-term expansionary cycle we entered after the 2008 financial crisis. Government and consumer deleveraging continues to suppress growth, particularly in the developed world, and Europe is sliding back into recession. But, monetary easing is building globally, with the European Central Bank (ECB), the Bank of England and emerging market central bankers opening the policy throttle. As we have stated in previous publications, the reduction in debt needed in Western economies will take years, not months, to work out. This means continued sluggish growth for the foreseeable future.

EARNINGS / VALUATIONS / CREDITS – Stocks still inexpensive after a more than 20% rally by the S&P 500 since October, offer attractive return potential

Investment and manufacturing employment seem to be picking up speed, but real wages have not yet responded. Corporate earnings and balance sheets continue to strengthen. Firms are taking advantage of low interest rates by refinancing for the long term. We expect corporate credit defaults to remain at very low levels and S&P 500 profits to reach all-time highs this year. Consensus estimates for 8-9% EPS growth in 2012 should be achieved. While stocks have been rallying since October, dividend yields in most developed markets are still above ten-year government bond yields.

CURRENCIES / INTEREST RATES – Headline inflation is abating, but core inflation is rising

As the Fed has stated, short-term interest rates will remain near zero into 2014. The ECB will launch another round of quantitative easing this quarter to support ailing banks. The result of continued, exceptionally loose monetary policy in the U.S., the U.K. and the euro zone is a rising risk of higher, longer-term inflation. We expect the U.S. dollar to be weak against emerging country currencies but relatively flat against developed market peers. At today's rates, we would not be a buyer of U.S. Treasuries or core Europe government bonds.

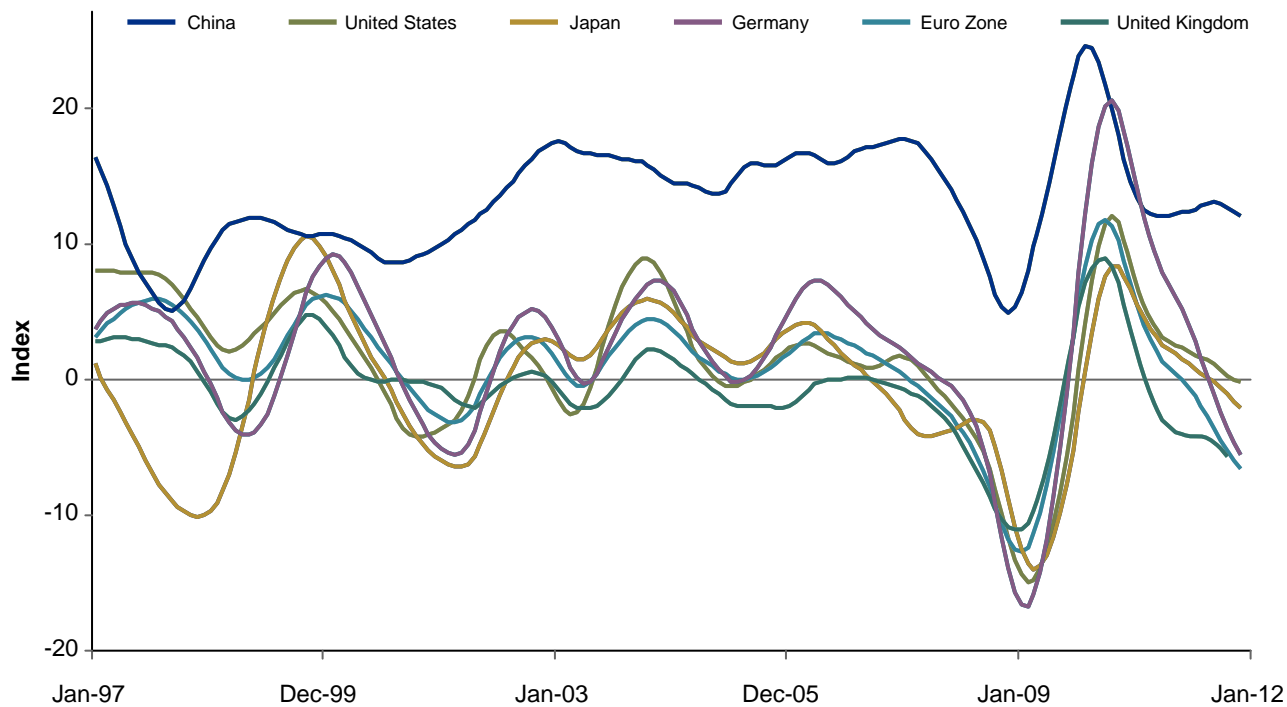
STYLE / SIZE / SECTORS – We would look for dividends and inflation protection

We remain overweight stocks globally. In the present economic and profit environment, we prefer cash-flow-generating companies that can pass through price increases. We have maintained our increased allocations to dividend-paying stocks. We also like high yield bonds; spreads are reasonable at 650 basis points over Treasuries and defaults are running at very low levels near 1.5%.

OECD Composite Leading Indicators

The global recovery has softened. Europe probably started 2012 in recession, as core countries succumb to the region's debt crisis.

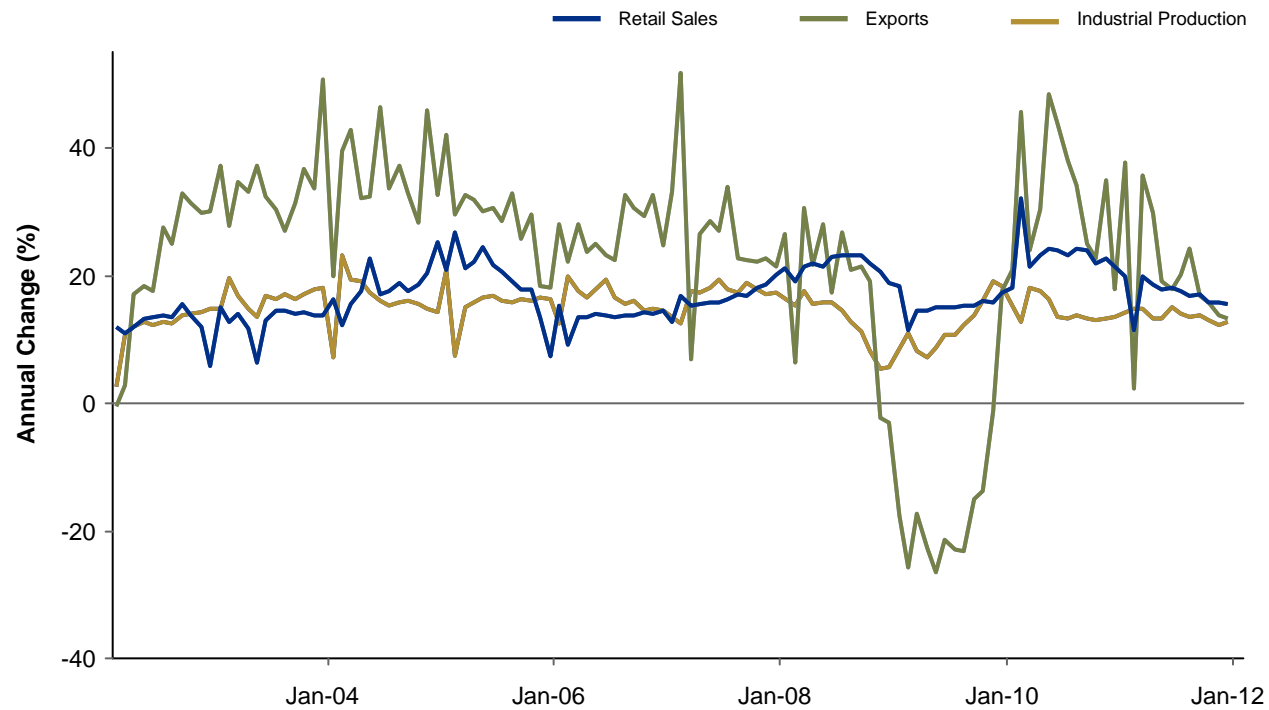
Leading Economic Indicators - 12-month rate of change (%)



Source: Organization 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

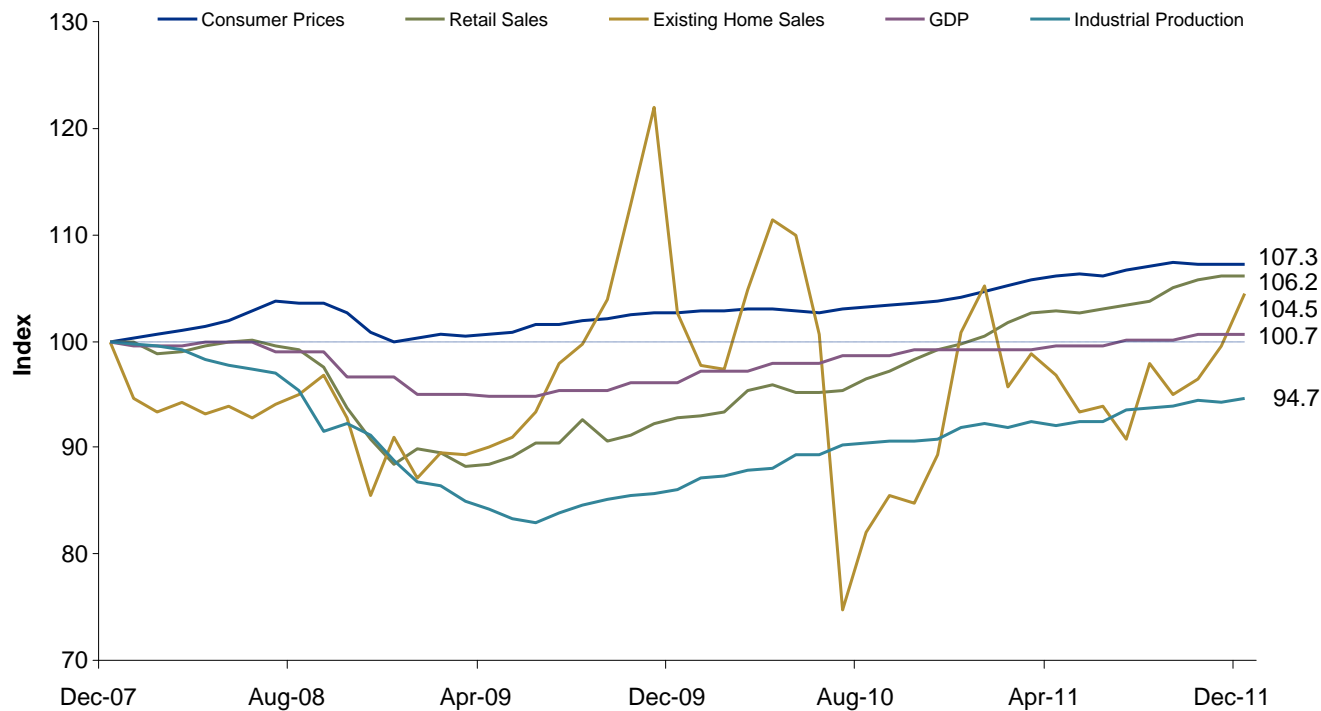
China Economy

We expect a 'soft landing' for China in 2012, with GDP growth around 8-9%. Robust domestic demand and infrastructure spending should partially offset weaker exports to developed countries.



U.S. Post-Crisis Economy

America's economic recovery has been anemic compared with past recessions. Significant long-term challenges include tax uncertainty, regulatory changes, entitlement reform and unsustainable debt levels.



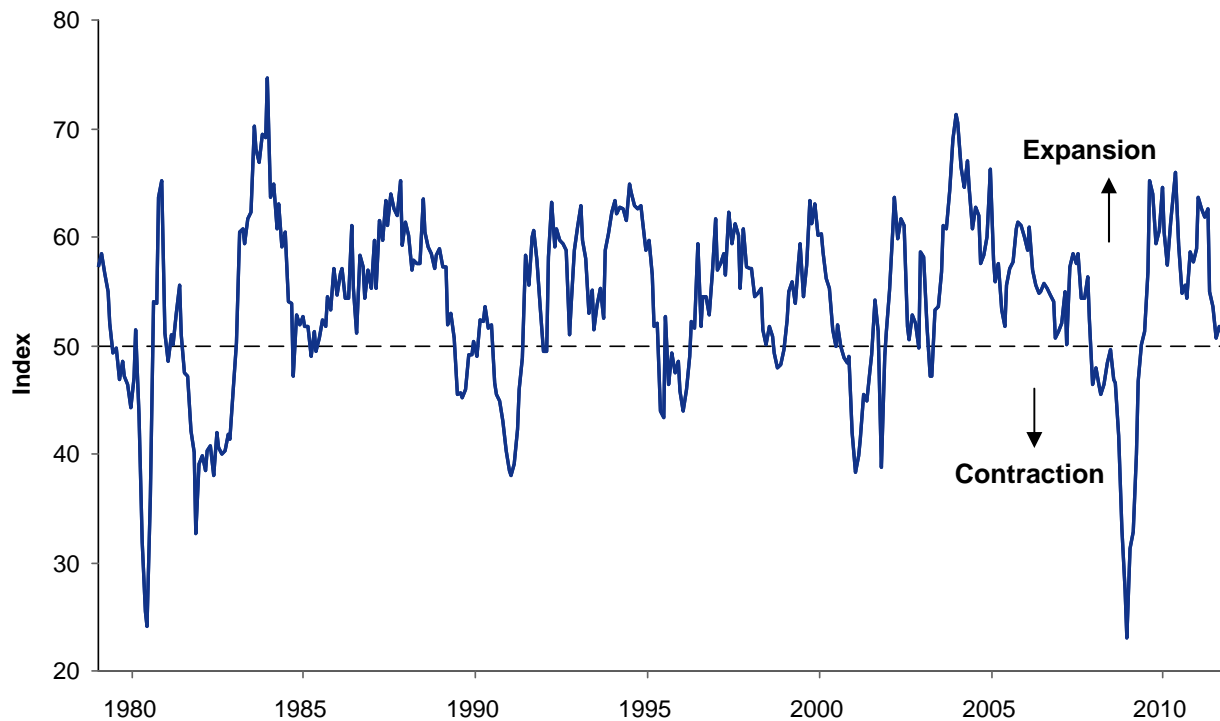
Note: Data indexed to 100 on December 31, 2007; as of December 31, 2011

Source: National Association of Realtors; U.S. Federal Reserve; U.S. Census Bureau; U.S. Bureau of Economic Analysis; U.S. Department of Labor; Allianz Global Investors Capital; see additional disclosure

U.S. Manufacturing

The outlook for manufacturing remains healthy. New orders, the most forward-looking component of the ISM survey, posted strong gains throughout the fourth quarter. The ISM employment index has been in expansion territory for more than two years.

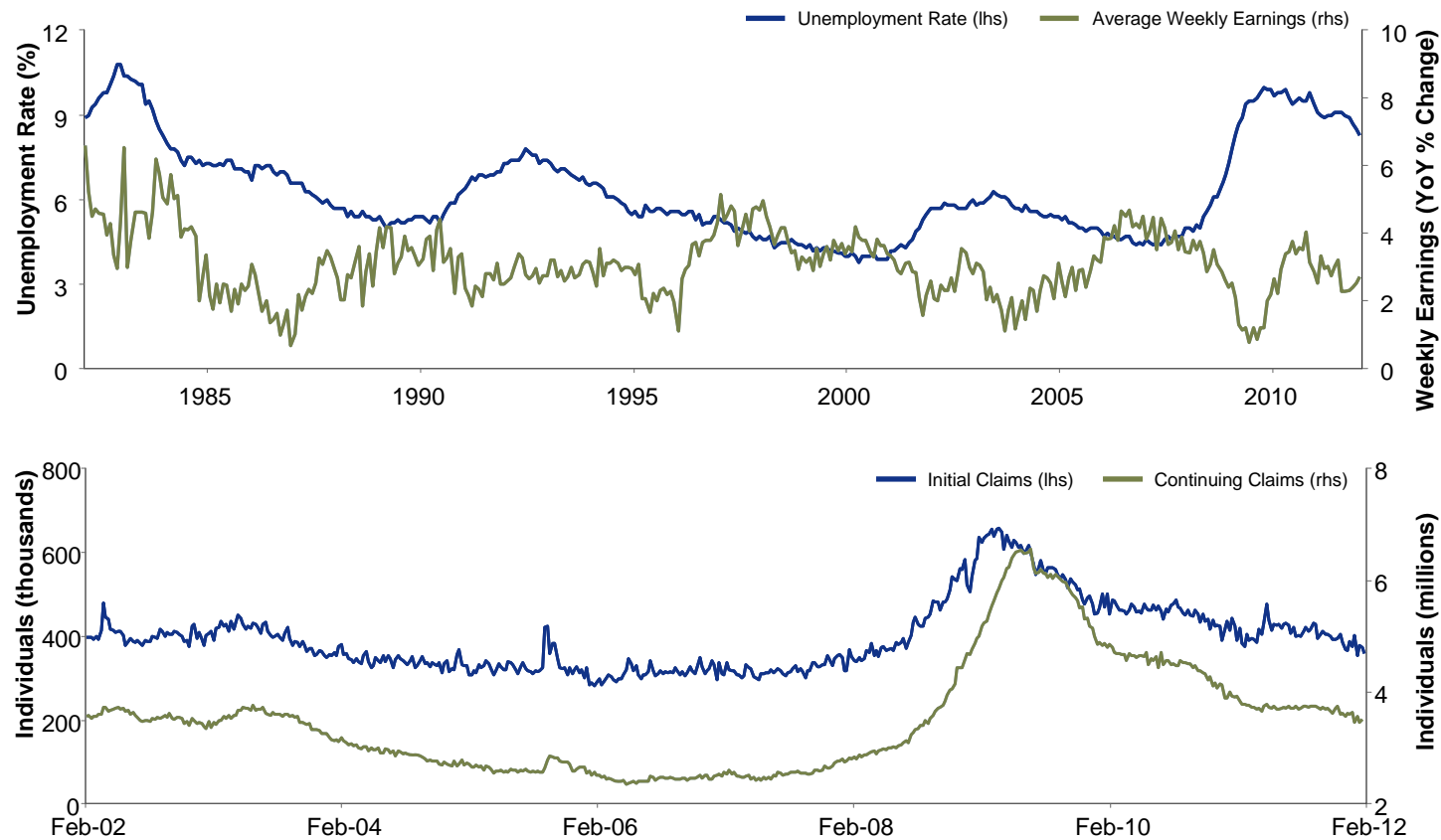
ISM Manufacturing Survey: New Orders



Source: Institute of Supply Management; Allianz Global Investors Capital; see additional disclosure; as of January 31, 2012

U.S. Unemployment and Earnings

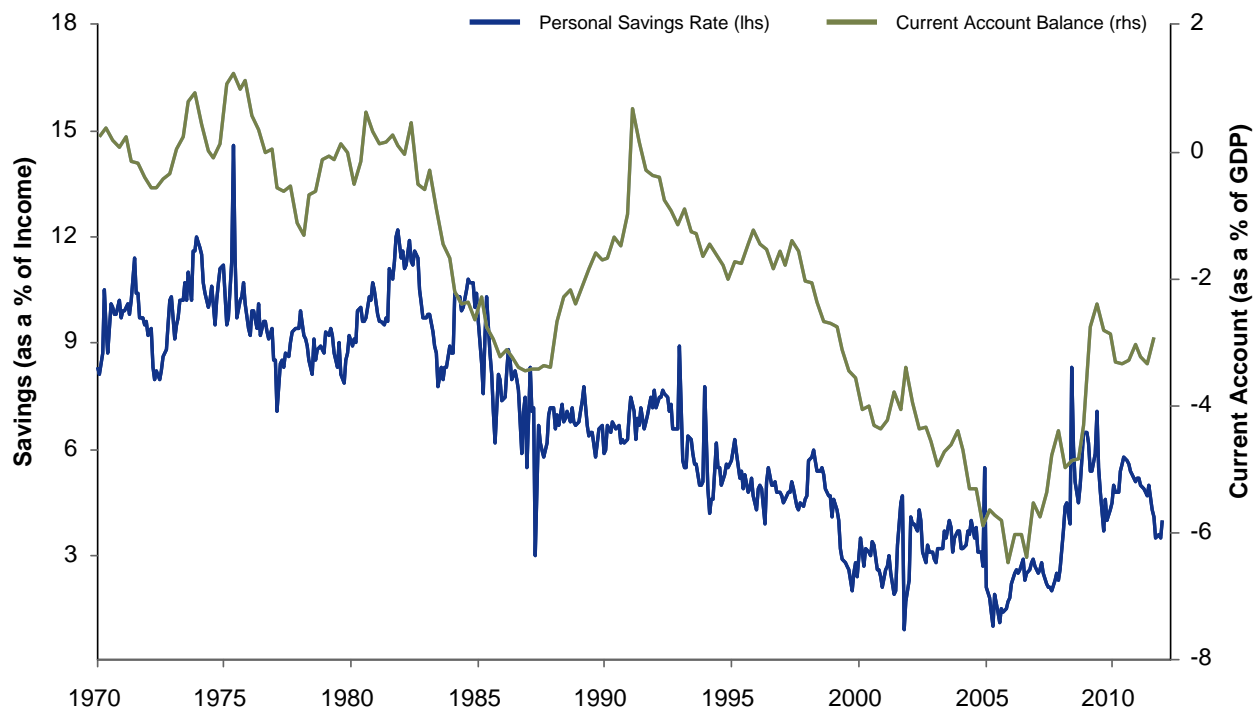
The labor market is slowly recovering. The economy shed about eight million jobs during the recession. ‘Discouraged’ workers may look for jobs again as hiring improves, keeping the unemployment rate well above pre-crisis levels for some time.



Note: Unemployment rate and earnings data as of January 31, 2012; initial claims as of February 3, 2012; continuing claims as of January 27, 2012
Source: U.S. Department of Labor; Allianz Global Investors Capital; see additional disclosure

U.S. Personal Savings and Current Account Balance

Americans are reverting to the old, unhealthy habit of financing consumption via reduced savings. A higher savings rate will help reduce the country's unsustainable current account deficit and encourage onshore investment.

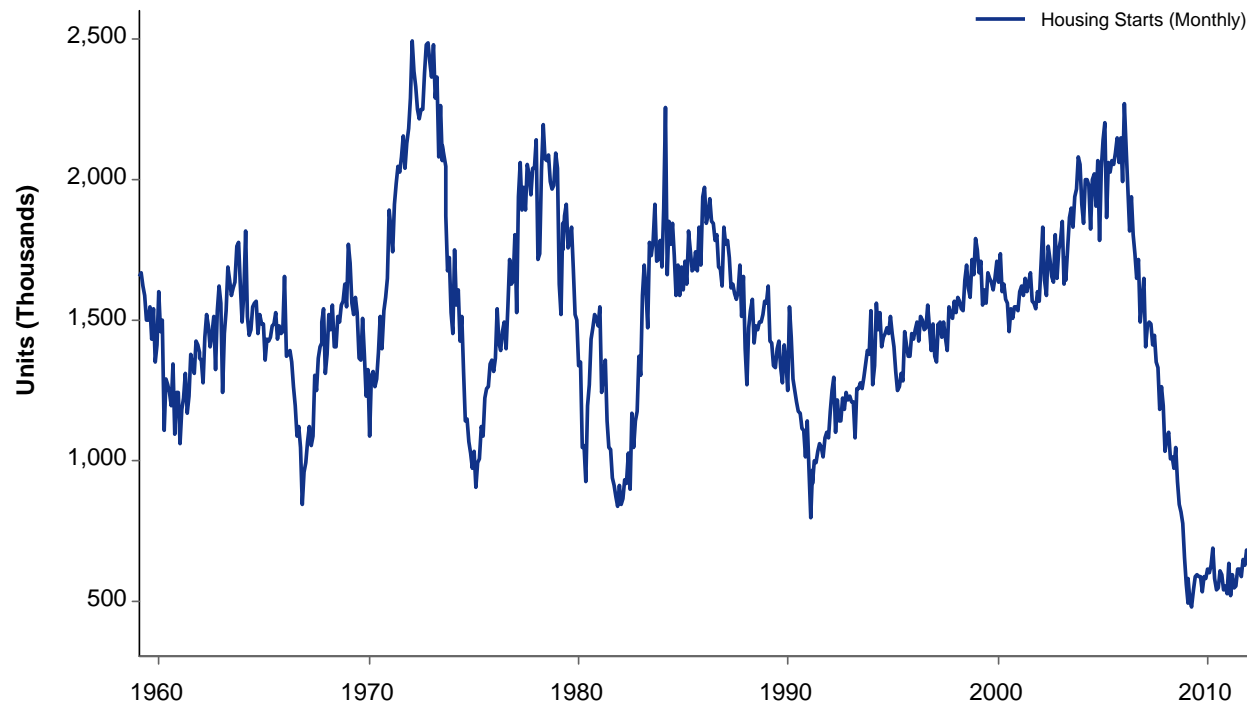


Note: Current account data is quarterly as of September 30, 2011; savings data is monthly as of December 31, 2011

Source: U.S. Bureau of Economic Analysis; Organisation for Economic Co-operation and Development; Allianz Global Investors Capital; see additional disclosure

U.S. Housing Market

The housing market remains weak. Real estate investment may contribute to GDP growth this year, but a strong housing recovery depends on sustained improvements in foreclosures and unemployment, which will take time.

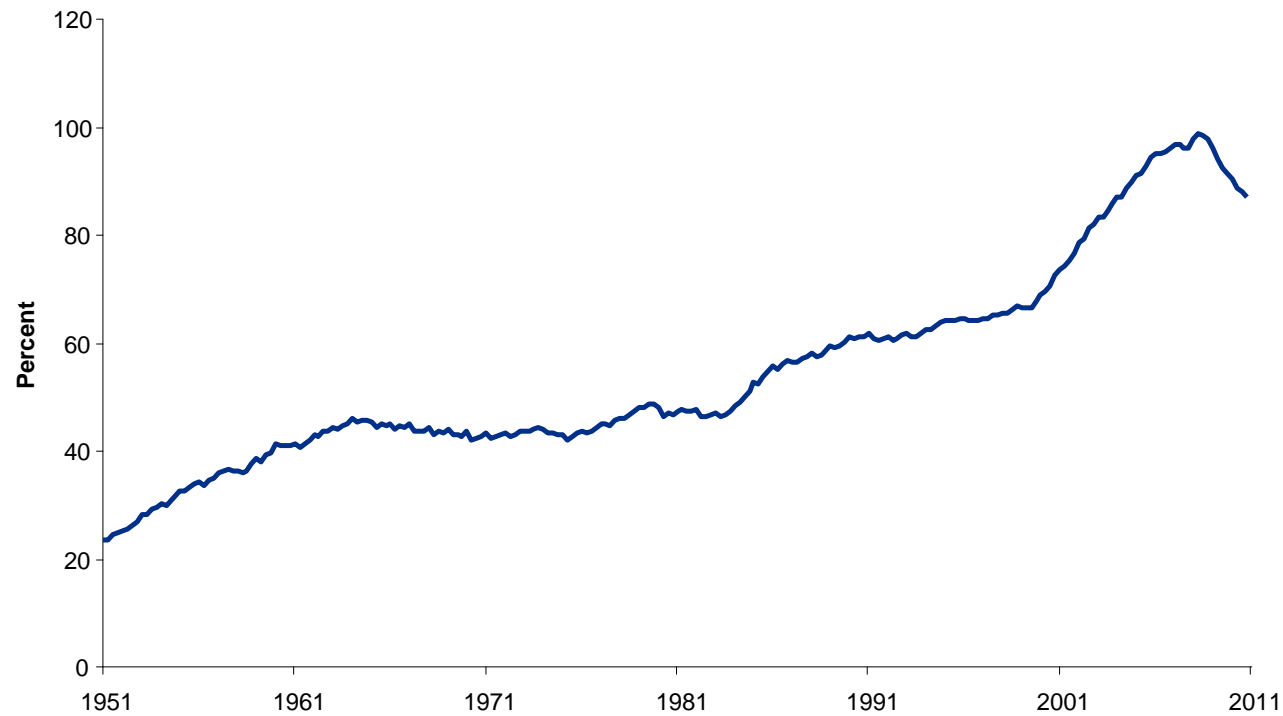


Source: U.S. Census Bureau; Allianz Global Investors Capital; see additional disclosure; as of December 31, 2011

U.S. Consumer Debt

As U.S. consumers de-leverage, their impact as an engine for global growth should diminish. Increased consumption in Asia and Latin America is helping fill the gap.

Total Household Debt (Percent of GDP)

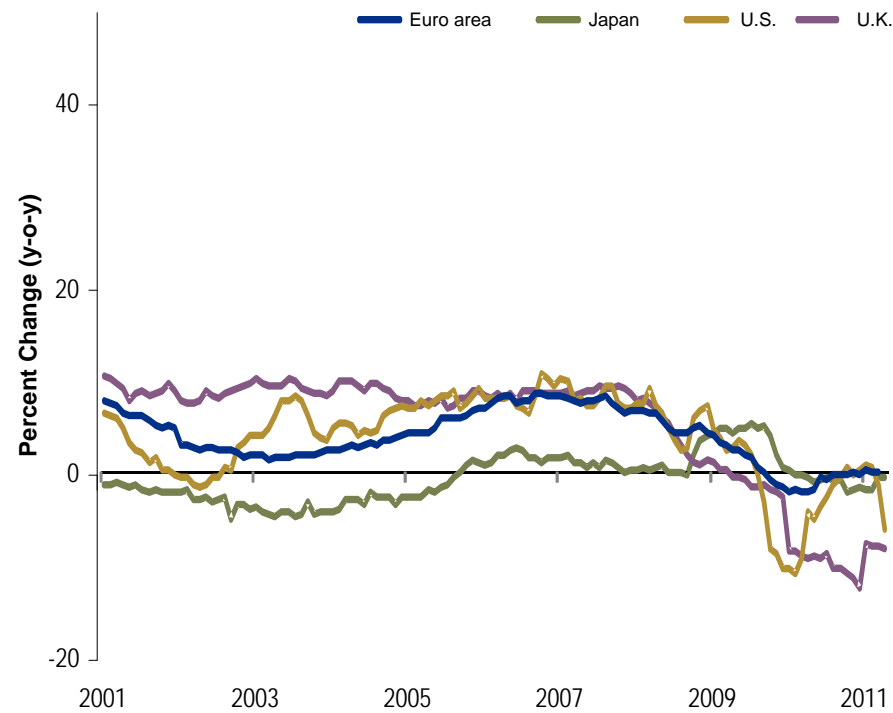


Source: U.S. Bureau of Economic Analysis; U.S. Federal Reserve; Allianz Global Investors Capital; see additional disclosure; as of September 30, 2011

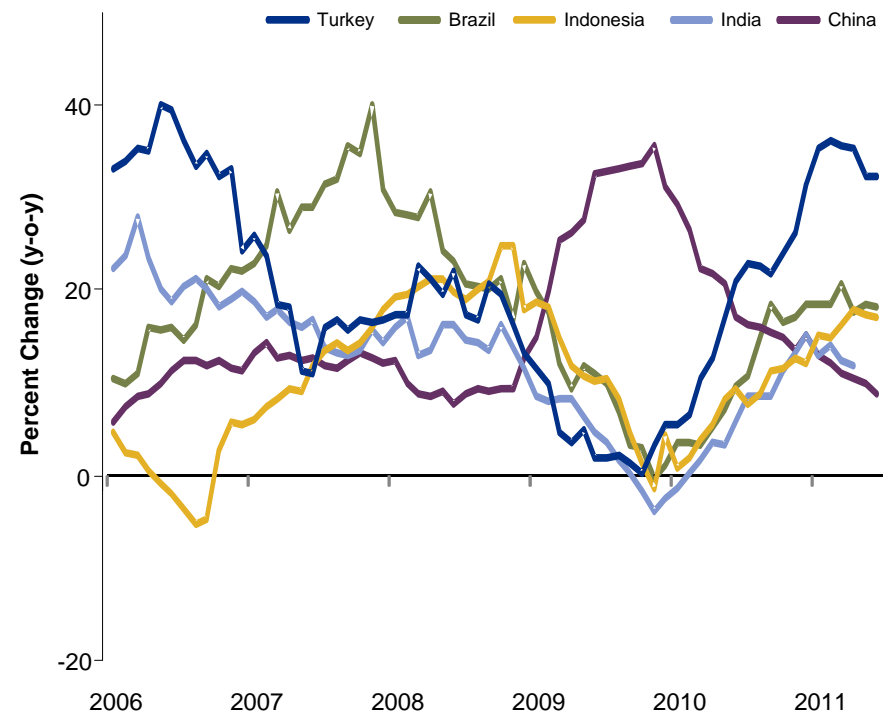
Global Credit Environment

While industrialized economies struggle to de-lever after years of over-borrowing, credit expansion in emerging markets is fueling growth and consumer demand.

Real Credit Growth



Real Credit Growth

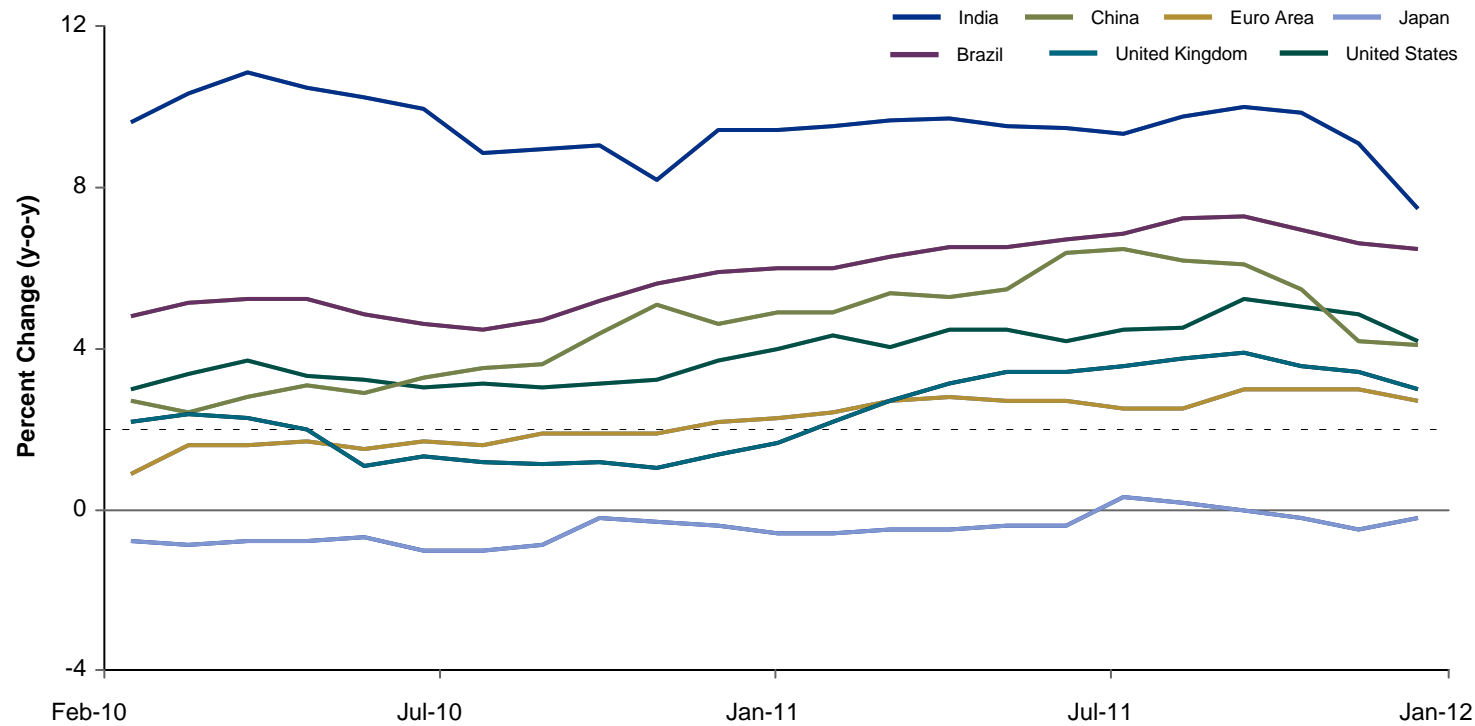


Note: Euro area as of March 31, 2011; Japan, U.S., U.K. and India as of April 30, 2011; all other figures as of June 30, 2011
Source: Haver Analytics; International Monetary Fund; Allianz Global Investors Capital; see additional disclosure

Global Inflation

Near-term price pressures should ease due to the combined effects of tougher year-over-year comparables and decelerating global growth. If the euro crisis is addressed effectively, disinflation will likely prove temporary, particularly for emerging markets.

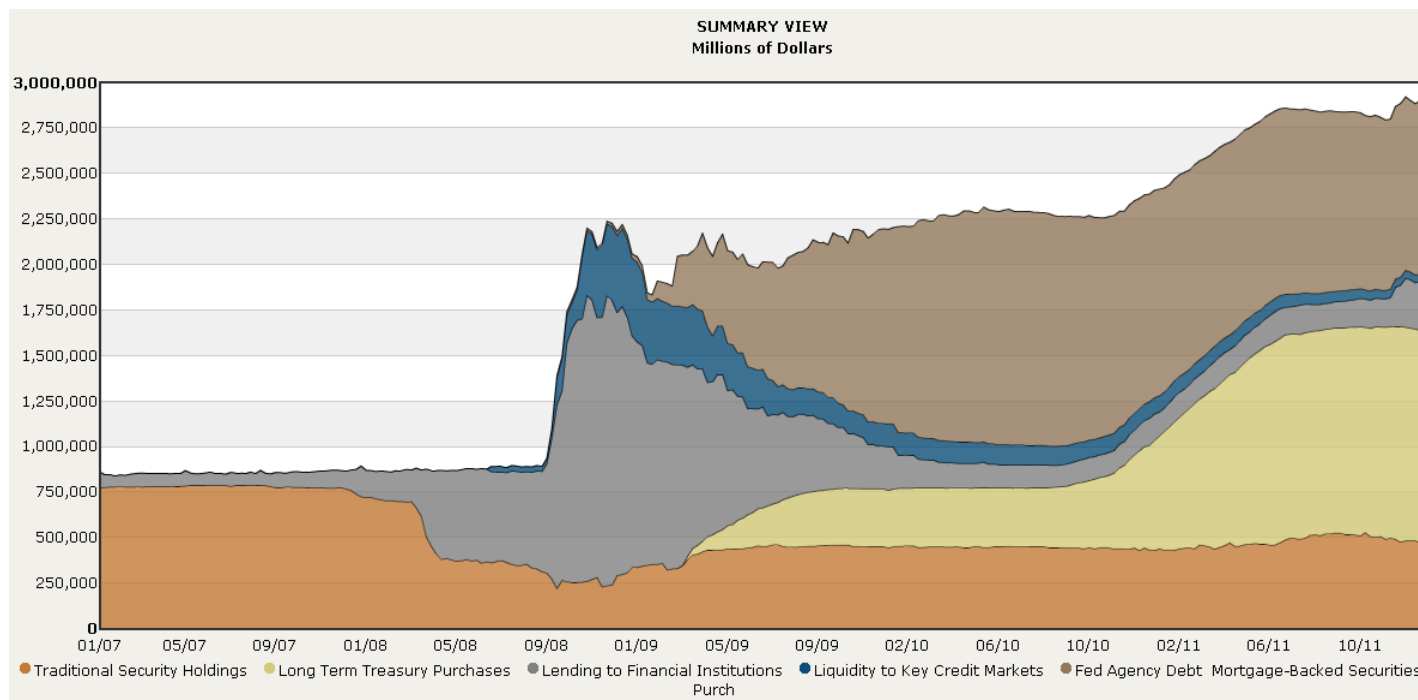
Headline Inflation



Source: Japan Ministry of Internal Affairs; U.K. Office for National Statistics; Eurostat; National Bureau of Statistics of China; IBGE; Indian Ministry of Commerce and Industry; U.S. Department of Labor; Allianz Global Investors Capital; see additional disclosure; as of December 31, 2011

U.S. Quantitative Easing

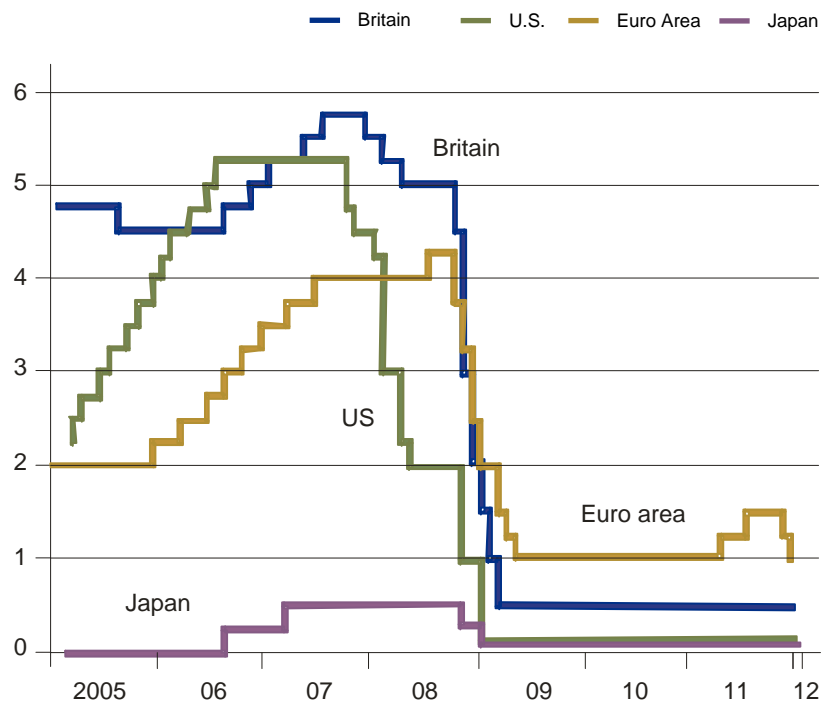
The Federal Reserve's foray into quantitative easing (QE) has made it the largest single holder of U.S. government debt. Except for higher asset prices, QE has not worked as advertised and should lead to higher inflation.



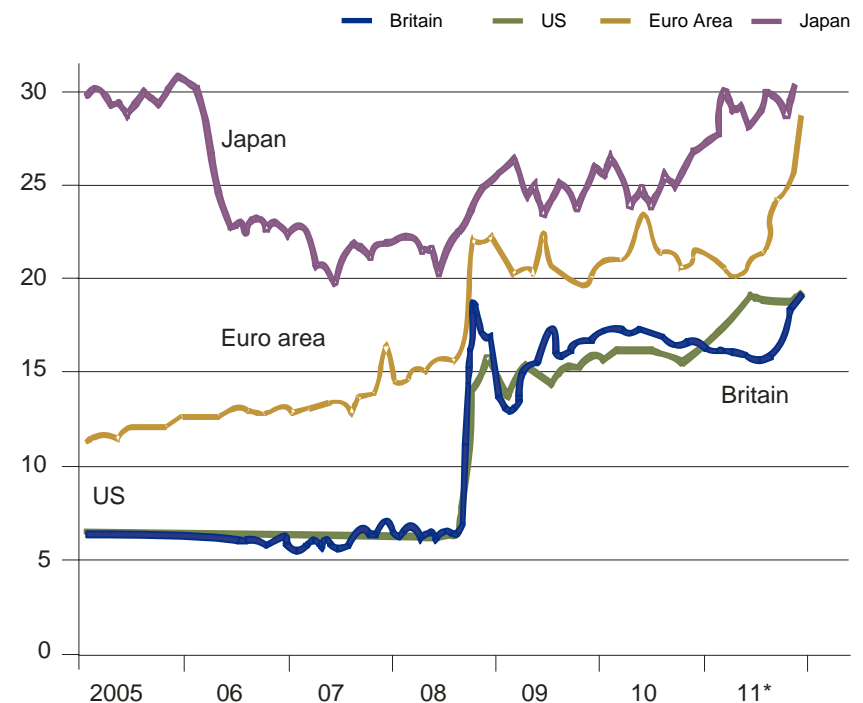
Global Monetary Policy

With conventional options diminished, QE (large-scale asset purchases) has become a favored monetary tool in the developed world. The resulting flood of freshly minted money raises the risk of higher longer-term inflation.

Central-bank Policy Rates, %



Central-bank Assets as % of GDP

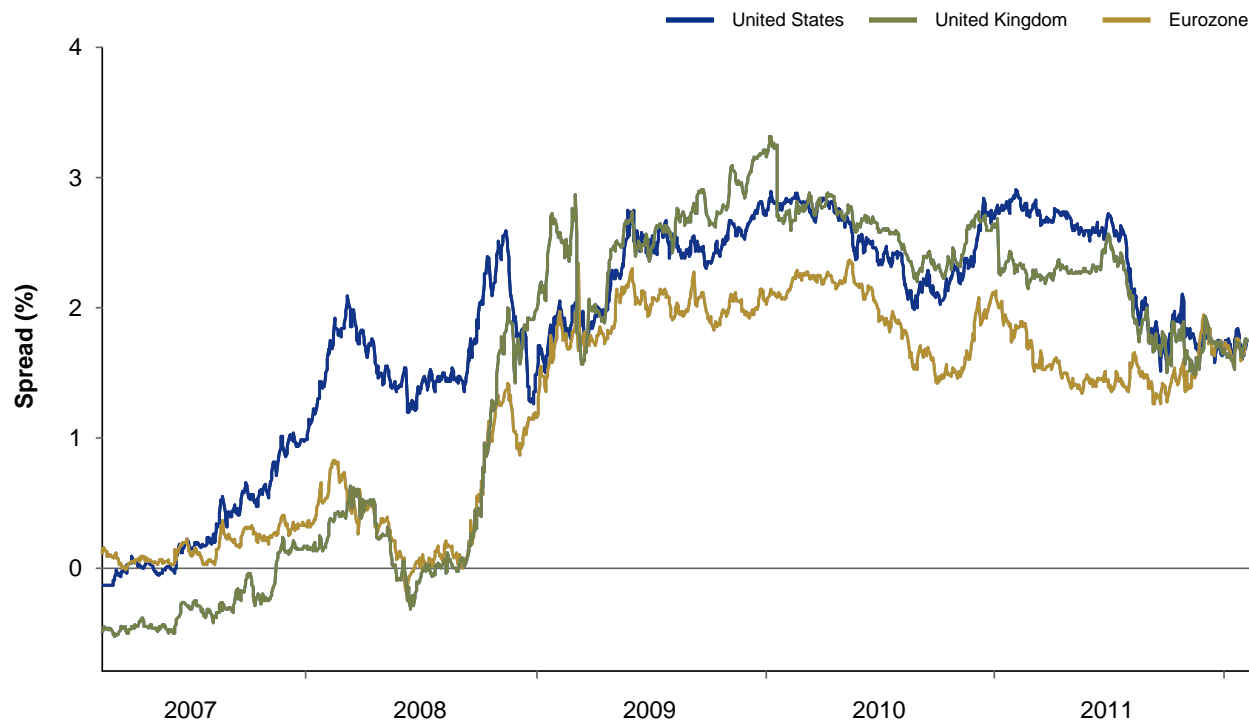


*October to December as % of Q3 GDP. Source: *The Economist*; Haver Analytics; European Central Bank; Allianz Global Investors Capital; see additional disclosure; as of January 7, 2012

Government Yield Curves

Once the euro crisis is resolved, spread expansion should resume. We expect U.S. and European short rates to remain very low well into 2013.

Yield Spreads (10-year less 2-year)



The Post-Crisis Credit World

Since 2007, negative credit actions have occurred primarily among developed countries, while 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				
	3-Jan-07		13-Jan-12	
	Rating	Outlook	Rating	Outlook
Netherlands	AAA	Stable	AAA	Negative
Finland	AAA	Stable	AAA	Negative
Luxembourg	AAA	Stable	AAA	Negative
United States	AAA	Stable	AA+	Negative
France	AAA	Stable	AA+	Negative
Austria	AAA	Stable	AA+	Negative
Belgium	AA+	Stable	AA	Negative
New Zealand	AA+	Stable	AA	Stable
Japan	AA-	Positive	AA-	Negative
Spain	AAA	Stable	A	Negative
Italy	A+	Stable	BBB+	Negative
Ireland	AAA	Stable	BBB+	Negative
Portugal	AA-	Stable	BB	Negative
Greece	A	Stable	CC	Negative

Emerging Markets				
	3-Jan-07		13-Jan-12	
	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
Peru	BB+	Stable	BBB	Stable
Colombia	BB	Positive	BBB-	Stable
India	BB+	Positive	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

Upgrade
Downgrade

Global Government Debt and Economic Policy

Public sector debt levels will rise substantially in the developed world in coming years.* This will leave government with fewer fiscal options during future downturns. Monetary policy will increase in importance. Developing countries remain comparably healthy.

Net Government Debt as a Percent of GDP*							
	2006	2008	2010	2012	2014	2016	Estimates Start After
Japan	84	97	117	139	153	167	2009
Greece	106	111	143	175	164	147	2010
Portugal	59	67	89	108	110	106	2009
Ireland	12	25	78	105	106	100	2010
Italy	90	89	99	101	98	95	2010
United States	42	49	68	78	85	89	2009
France	60	62	77	84	85	82	2010
United Kingdom	38	46	68	77	77	72	2009
Spain	31	30	49	59	63	66	2010
Germany	53	50	58	57	55	55	2010
Mexico	32	36	39	40	40	40	2010
Brazil	47	38	40	37	35	33	2010
Poland	15	10	21	26	27	26	2008
Chile	-2	-18	-2	-8	-8	-8	2010
Saudi Arabia	2	-46	-50	-56	-57	-50	2009

100% and up
70 – 99%
40 – 69%
Below 40%

Developed Markets

Emerging Markets

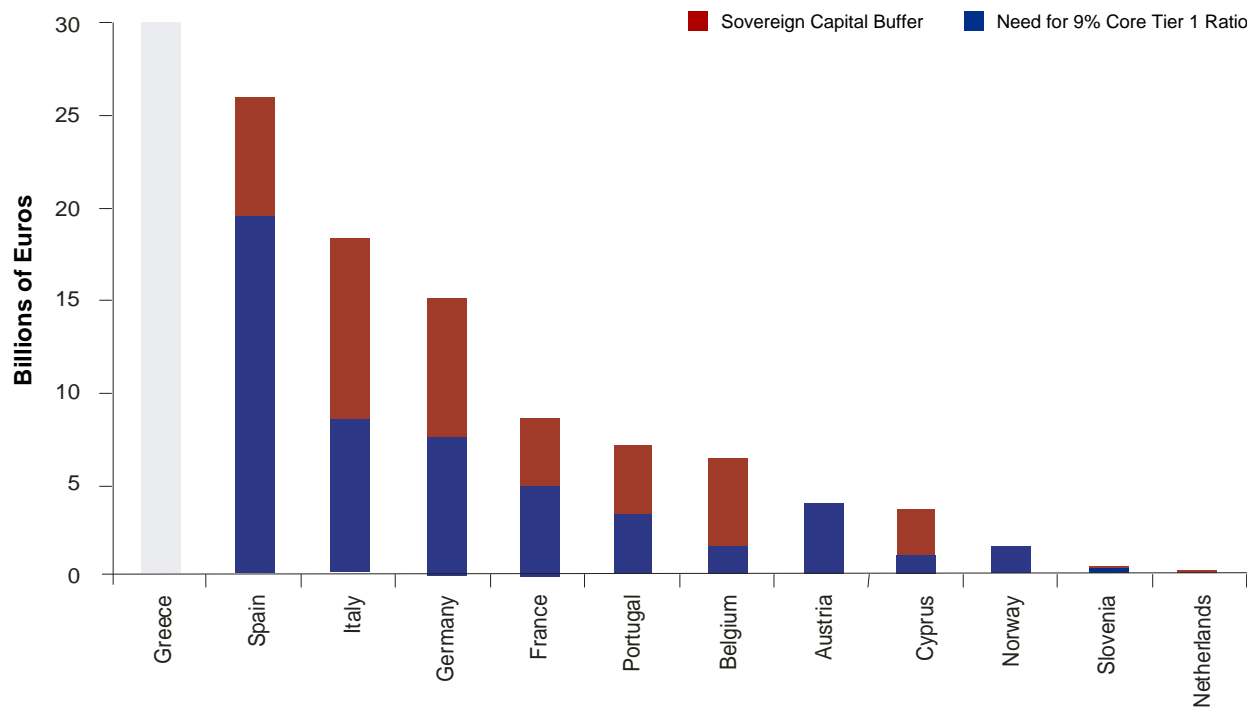
*International Monetary Fund projections

Source: International Monetary Fund; Allianz Global Investors Capital; see additional disclosure; as of September 2011

European Bank Capital

European banks must plug a €85 billion capital hole, according to regulators (does not include €30 billion for Greece). Bank deleveraging, asset sales and lending and financing cutbacks will likely weigh on regional economic activity and could impact the U.S., Asia and emerging markets.

European Bank Capital Needs

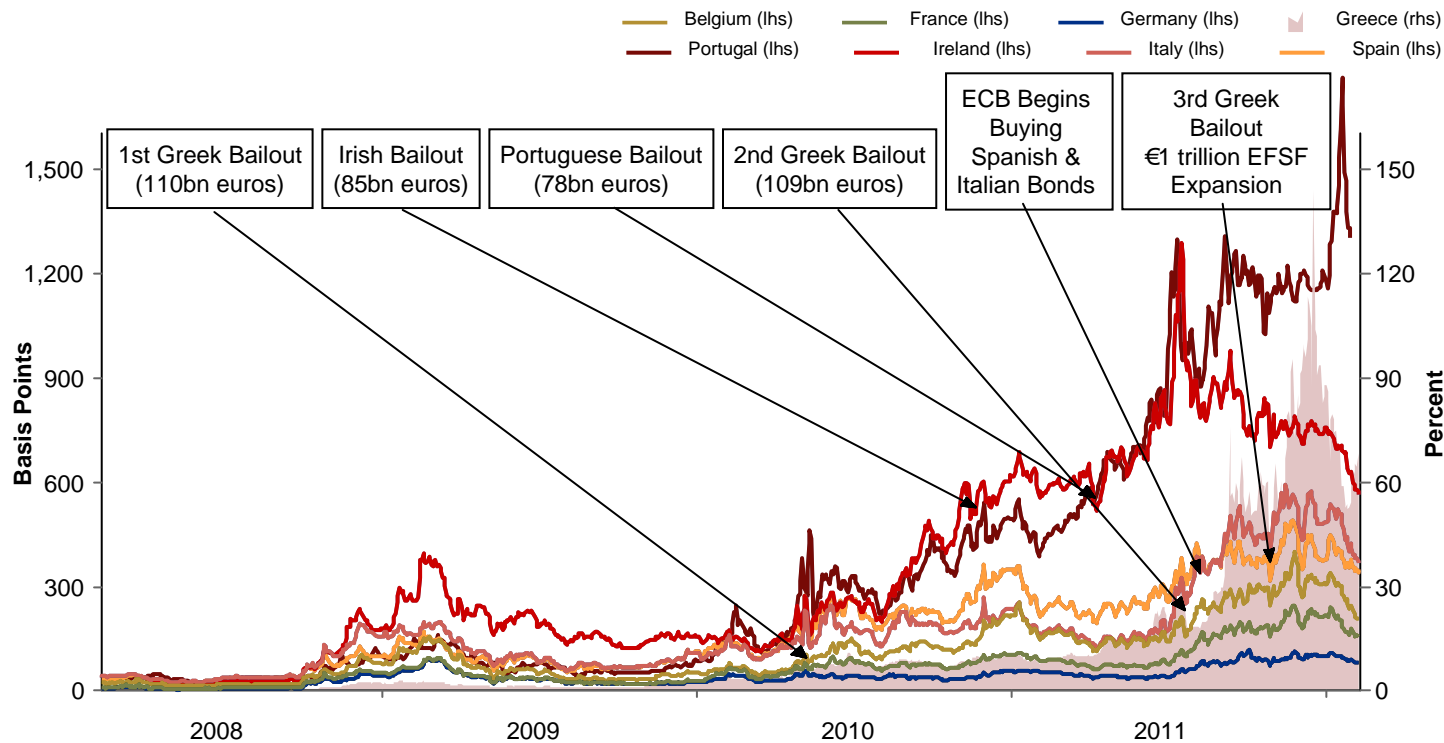


Source: European Banking Authority; International Monetary Fund; Allianz Global Investors Capital; see additional disclosure; as of January 24, 2012

European Sovereign Default Risk

Policy risk remains the primary threat to the global recovery. Europe's leaders must back words with actions and protect countries with temporary liquidity issues (Spain and Italy) from contagion from governments that are insolvent (Greece and Portugal, maybe Ireland).

Credit Default Swap Spreads (5-Year)



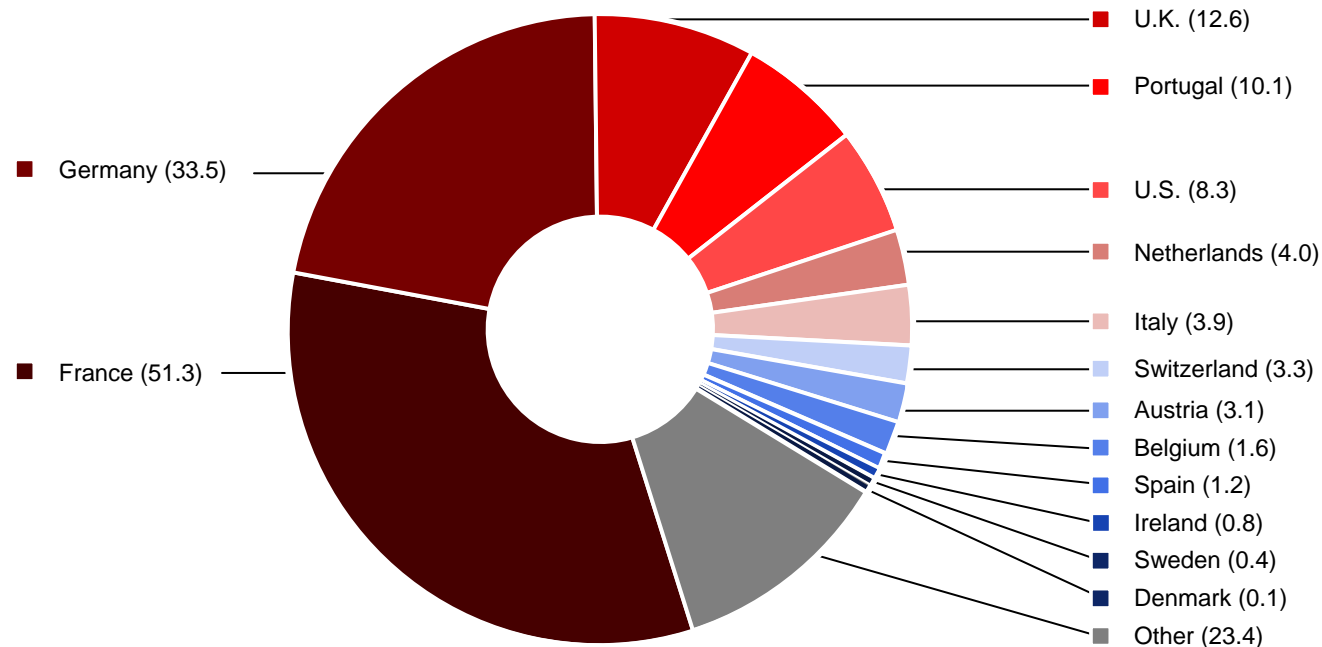
Note: 100 basis points equals 1%

Source: *The Wall Street Journal*, FactSet; Allianz Global Investors Capital; see additional disclosure; as of February 8, 2012

Greek Default Fallout

About 80% of Greek debt is owned by European banks. French and German firms are most exposed.

Foreign Bank Exposure to Greek Debt (\$158 Billion)
Public and Private (\$ Billions)

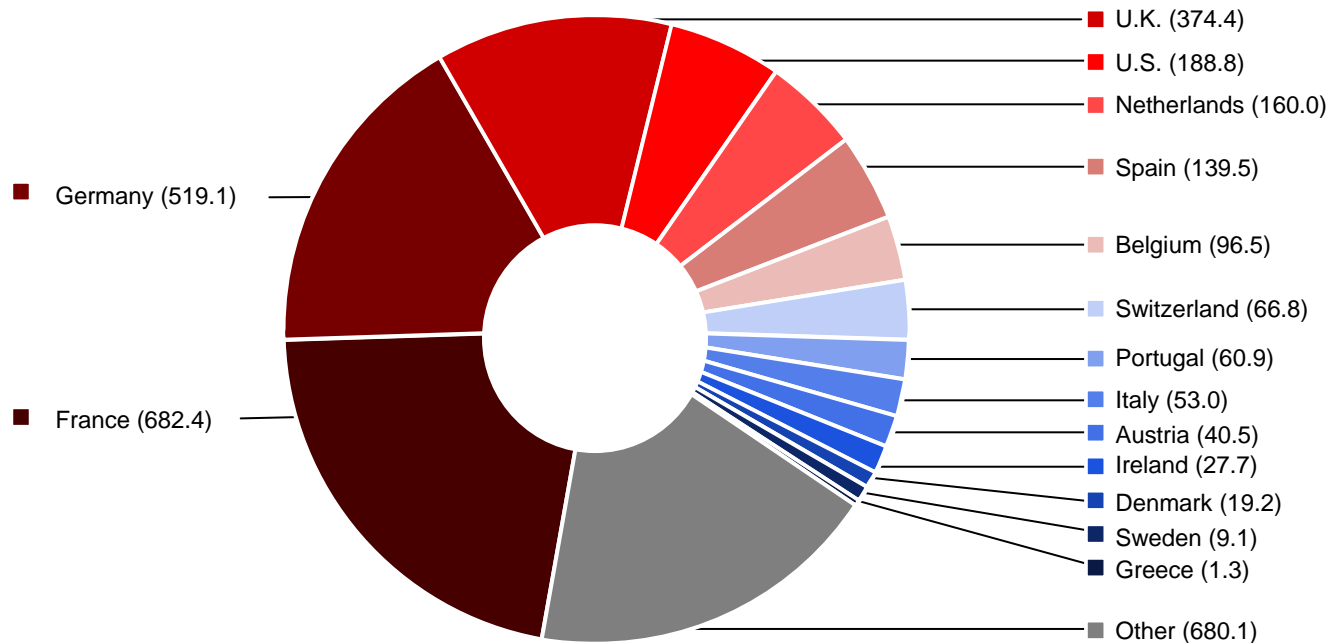


Source: Bank of International Settlements; Allianz Global Investors Capital; see additional disclosure; as of June 30, 2011

The Threat of a Broader Crisis

Europe must act decisively to prevent financial contagion. Pressure to remedy the crisis should remain high.

Foreign Bank Exposure to PIIGS* Debt (\$3.1 Trillion)
Public and Private (\$ Billions)



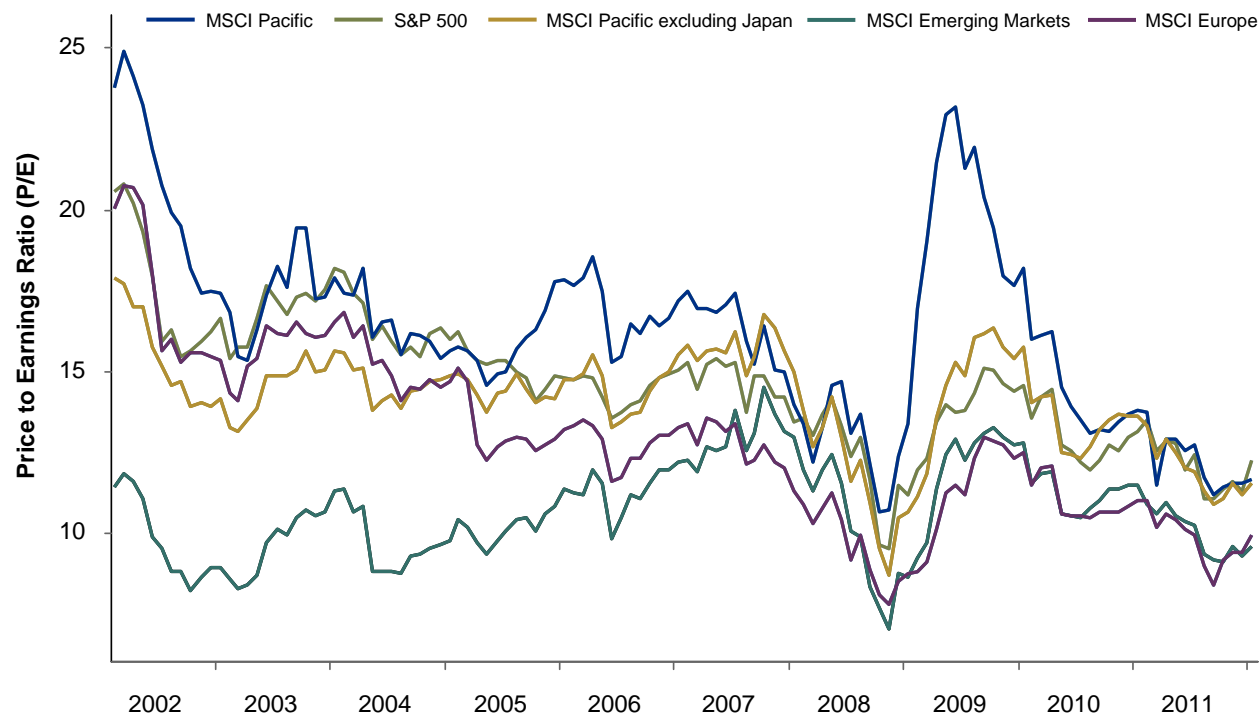
*Portugal, Ireland, Italy, Greece and Spain

Source: Bank of International Settlements; Allianz Global Investors Capital; see additional disclosure; as of June 30, 2011

Global Forward Price-to-Earnings

Stocks look cheap relative to profits. In January, the S&P 500 traded at a more than 15% discount to its ten-year average P/E. The MSCI Emerging Markets Index was at a 10% discount. Stocks in Asia were nearly 30% cheaper than normal.

Forward P/E - Next 12 Months Estimate (Monthly)

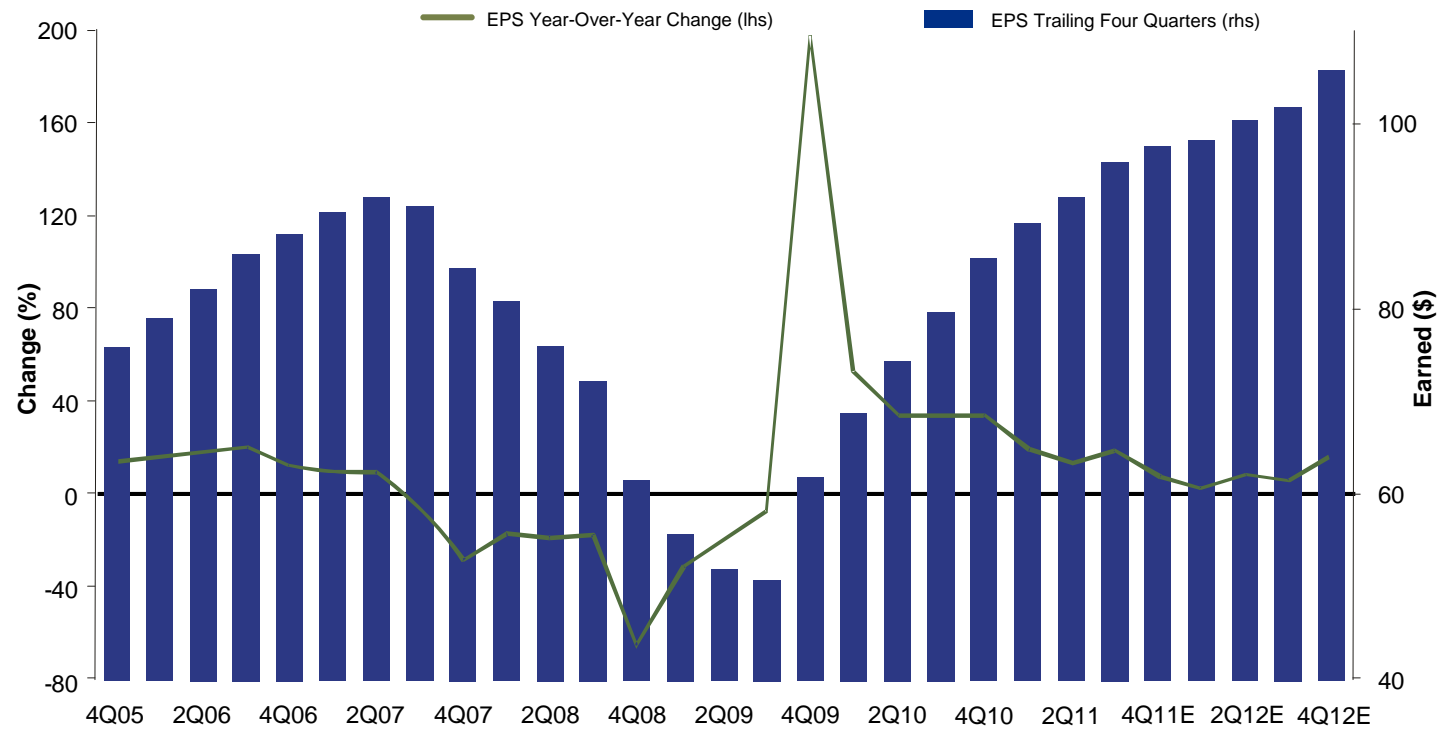


Source: IBES; MSCI; Standard and Poor's; Allianz Global Investors Capital; see additional disclosure; as of January 31, 2012

U.S. Earnings Growth

Bottom-up forecasts for corporate earnings held up well in the face of macro threats last year. Consensus estimates indicate 8.8% year-over-year growth in 2012, a rate we think should be achievable.

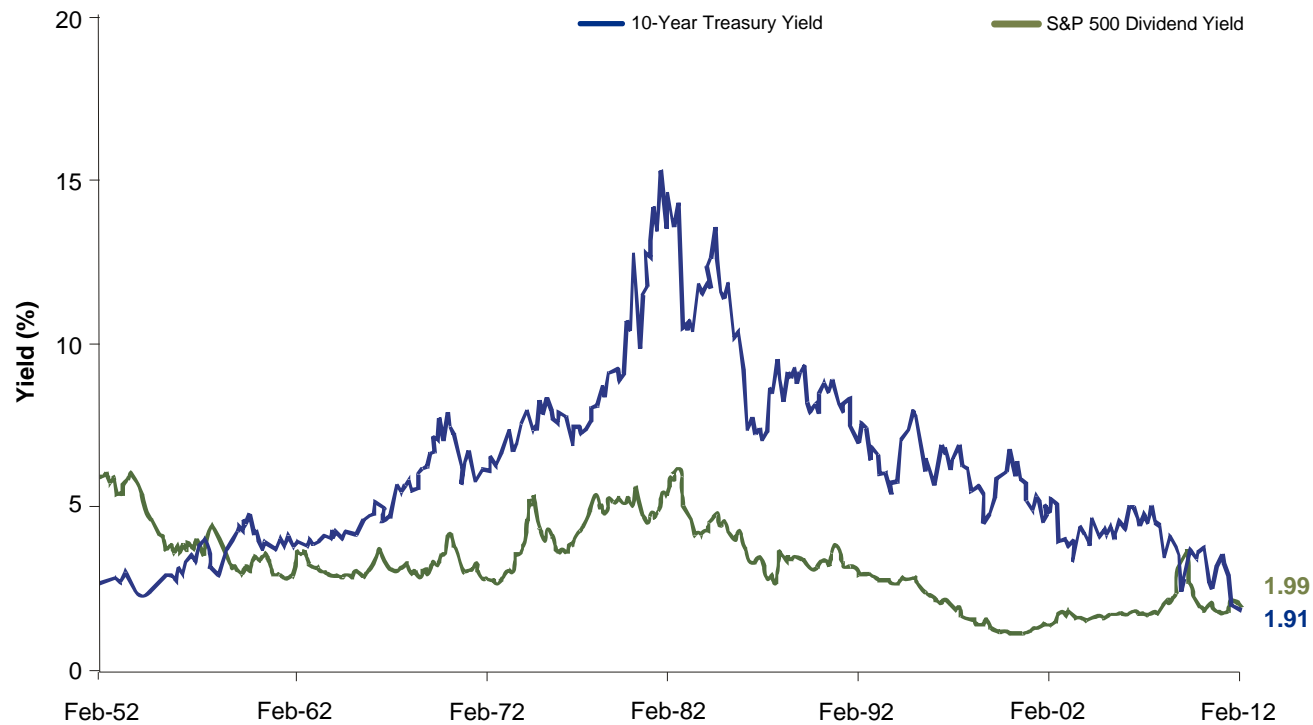
S&P 500 Index Earnings



Source: Thomson Reuters; Standard and Poor's; Allianz Global Investors Capital; see additional disclosure; as of February 3, 2012

Dividend Investing

The S&P 500 Index provides a larger 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.



Source: Robert Shiller; Standard and Poor's; Allianz Global Investors Capital; see additional disclosure; as of February 6, 2012

U.S. Corporate Debt Spreads

Macro-driven spread expansion has opened a window of opportunity for investors. Compared to prior peak spread periods, today, the balance sheet of the average high yield issuer is far stronger. Default rates are low and should remain low for an extended period.

Corporate Debt Spreads*



*Debt spreads are equal to yield-to-worst less comparable U.S. Treasuries

Source: Bank of America Merrill Lynch; Fitch; Allianz Global Investors Capital; see additional disclosure; as of February 8, 2012

Market Environment: Disclosure

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