PIMCO

San Diego City Employees' Retirement System
*December 2016*

# 2017 EM Outlook

A company of Allianz

# Biographical information

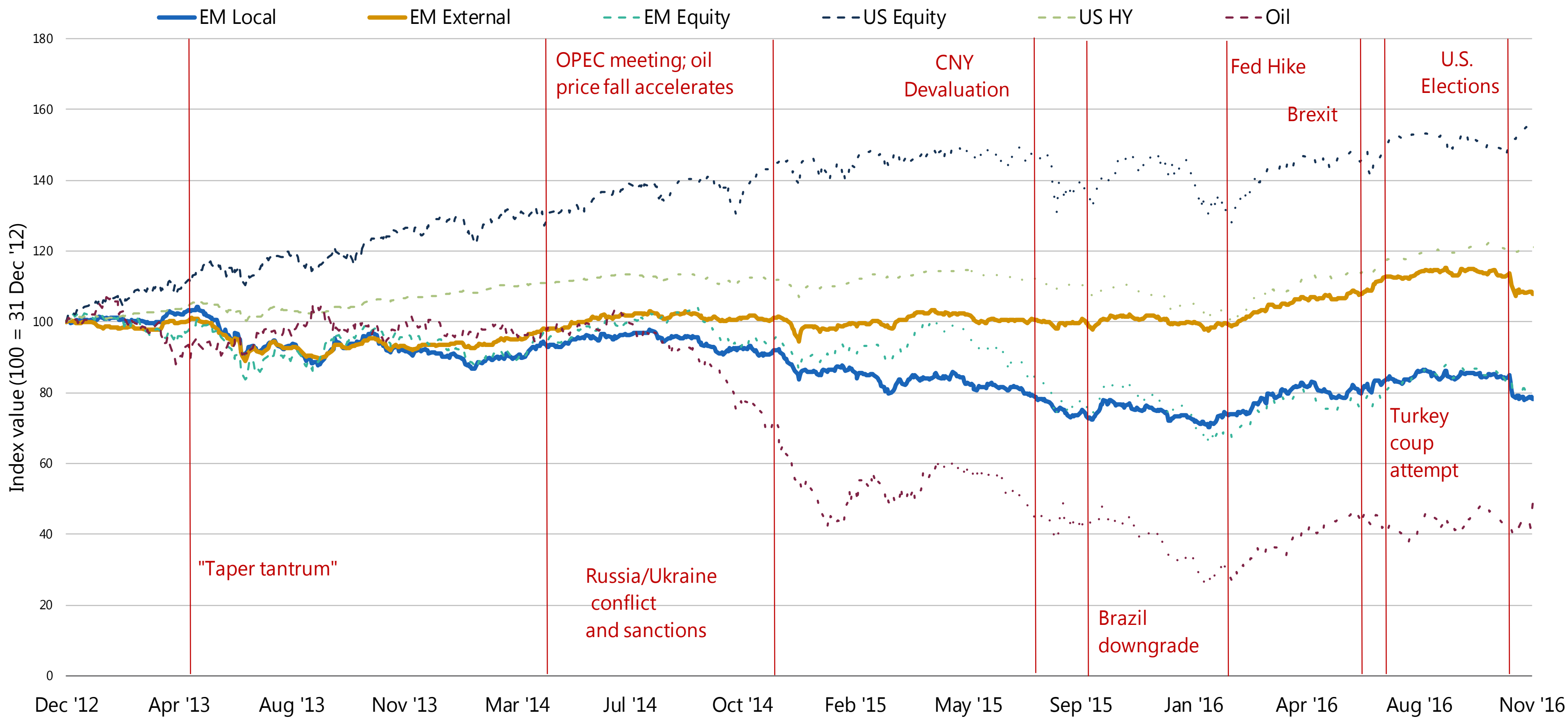
## Michael A. Gomez

Mr. Gomez is a managing director in the Newport Beach office, a portfolio manager and head of the emerging markets portfolio management team. Prior to joining PIMCO in 2003, he was responsible for market making and proprietary trading of emerging market bonds at Goldman Sachs. Prior to that, he spent a year in Colombia serving as a financial consultant to the Ministry of Finance and Public Credit. In addition, Mr. Gomez has served on numerous other committees providing advisory assistance to emerging market countries or a market practitioner's perspective to index providers. He has 22 years of investment experience and holds an MBA from the Wharton School of the University of Pennsylvania, where he also received his undergraduate degree.

## Sasha Talcott, CFA

Ms. Talcott is a vice president and account manager in the Newport Beach office, focusing on institutional client servicing. Prior to joining PIMCO in 2012, she was director of communications and outreach for Harvard Kennedy School's Belfer Center for Science and International Affairs, a research center that focuses on topics ranging from international security to energy policy. Previously, she was a business reporter for the Boston Globe, where she covered the banking and insurance sectors. She holds an MBA from MIT Sloan School of Management and received an undergraduate degree from Northwestern University.

# A combination of external and internal factors since 2013 created a "perfect storm" - presenting an attractive entry point for investors

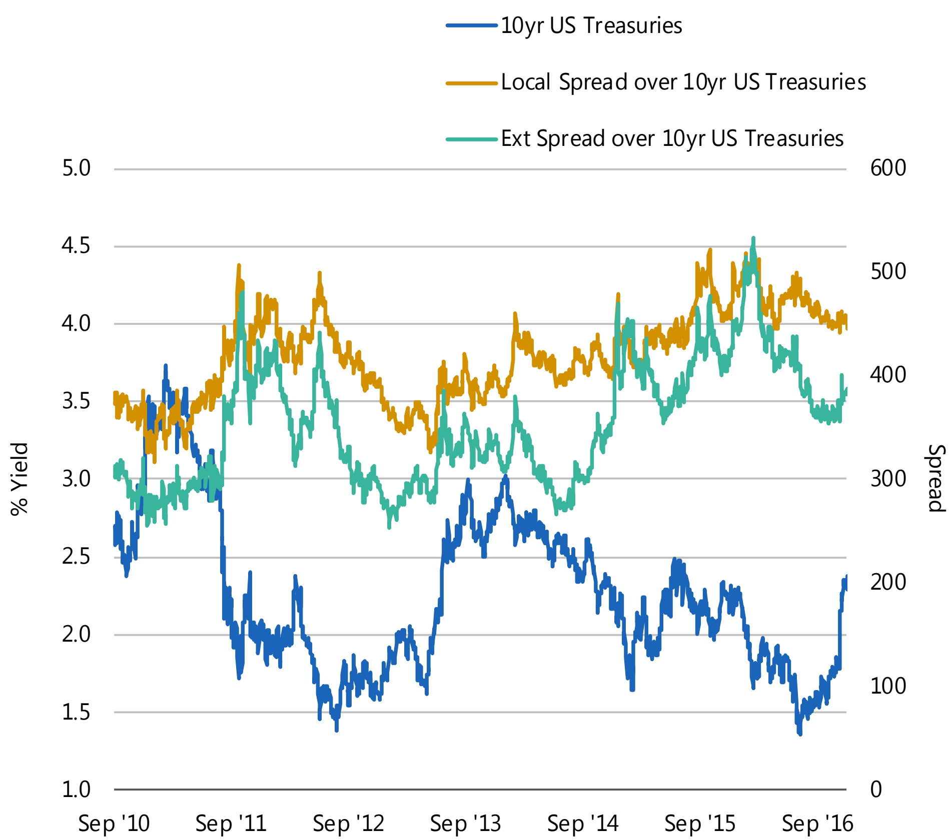



- Local currency denominated assets bore the brunt of the adjustment but hard currency bonds disappointed, too.
- Positive catalysts are emerging; following a prolonged period of underperformance it may be a good entry point for long-term investors.

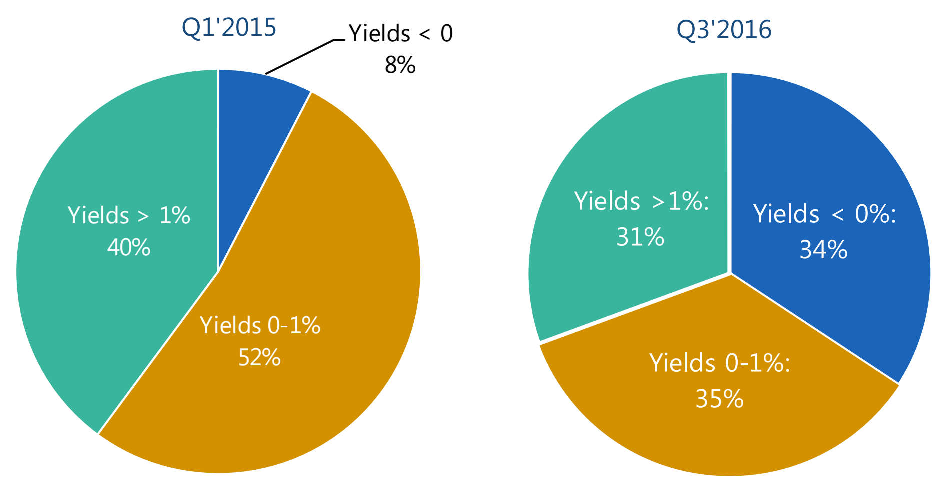
As of 13 December 2016. SOURCE: PIMCO, Bloomberg.
EM Local is represented by the JPMorgan GBI-EM Global Diversified Index; EM ($) is represented by the JPMorgan EMBIG; EM Equity is represented by MSCI Emerging Markets Index; US Equity is represented by the S&P 500 Index; US IGC is represented by the Barclays U.S. Credit Index; US High yield is represented by the BofA ML US High Yield Index
Refer to Appendix for additional index and risk information.

# Global search for yield and amelioration of external headwinds focusing attention on EM opportunities

## EM spreads vs US Treasury yields




## Global bonds with negative yields




*Yield Breakdown of Government Bonds in the Barclays Global Agg Treasury Index*

As of 30 November 2016. Right chart as of 30 September 2016
SOURCE: Bloomberg, Bank of America Merrill Lynch
Refer to Appendix for additional investment strategy and risk information.

# The 3 C's: Potential Catalysts for Emerging Markets

***China***

***Commodities***

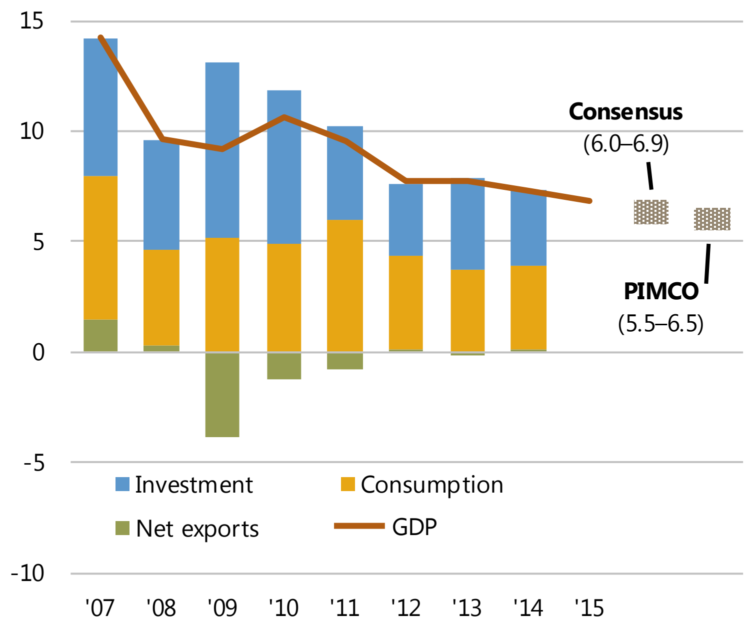
***Central Banks***

As of 30 June 2016
SOURCE: PIMCO
Refer to Appendix for additional investment strategy and risk information.

# China: A slowdown to one of the highest growth rates in the world

***Resilience amid proven willingness to deploy an armada of policy tools***

## PIMCO expects a moderation but not a hard landing

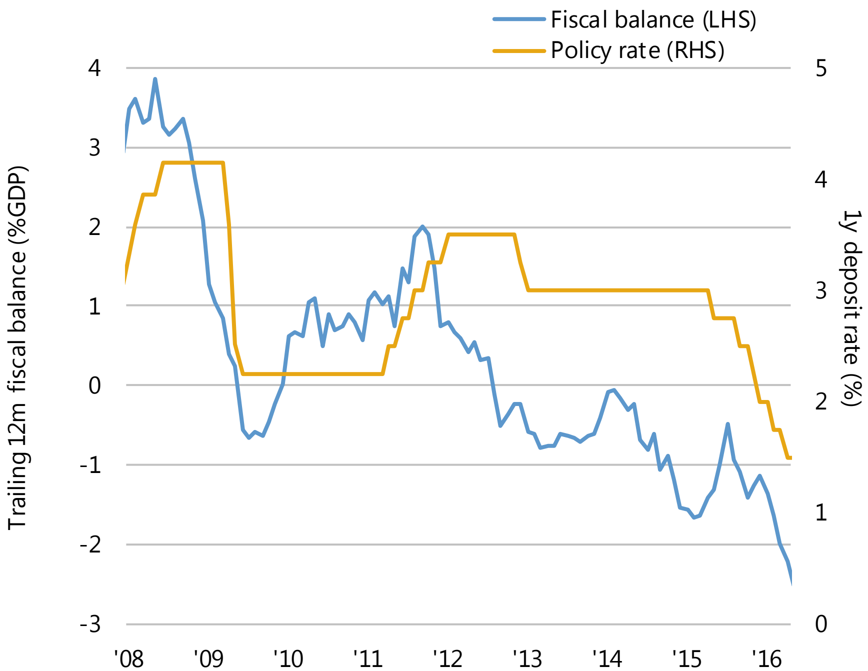



The combination of an economic slowdown, seemingly reactionary policymaking, and poor communicating had propagated uncertainty

The economic structure is in transition: Expect volatility

Slower growth may be a headwind for Asia ex-Japan

## Easing underway on both the monetary and fiscal fronts




Policymakers have reacted with an armada of easing measures:

- Moderately paced CNY devaluation
- Monetary policy easing
- Loosening of lending standards
- Expansionary fiscal stimulus

As of 30 June 2016

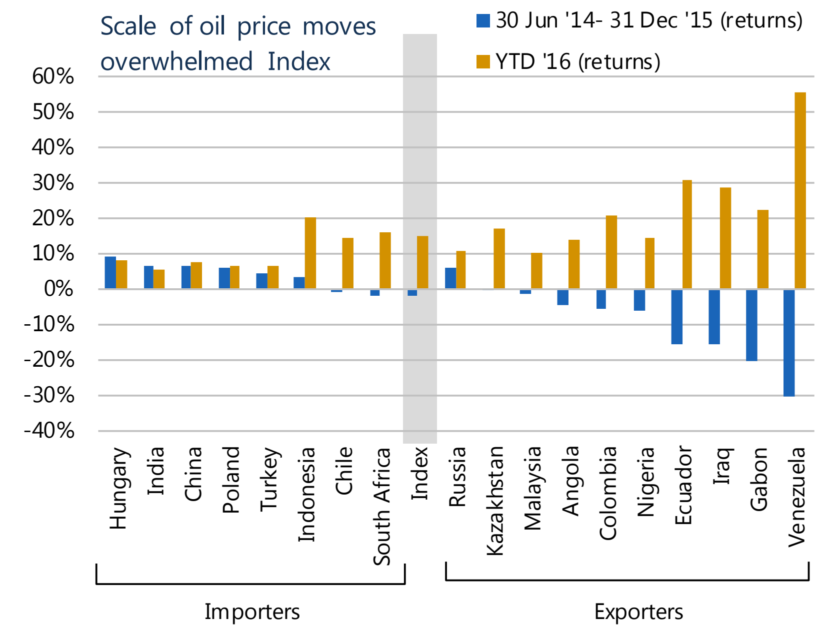
SOURCE: China National Bureau of Statistics, CEIC, Bloomberg

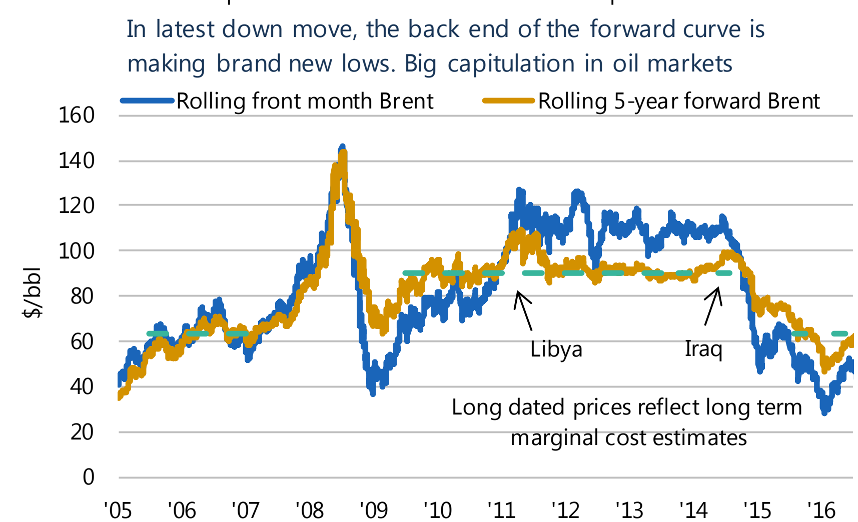
Refer to Appendix for additional outlook and risk information.

# Commodities: A highly differentiated impact but the worst is likely over

- Commodity exporting countries were impacted by the decline in commodity prices asymmetrically vs. commodity importing countries
- As economies adjusted and commodity prices rose, sovereign bonds of exporting countries recovered
- Although the supply overhang may continue to weigh on spreads, back end oil prices have found some support driven by balancing supply/demand dynamics
- U.S. rig count is at a 15-year low
- Outside of the Middle East, rigs have declined to 10-year lows globally

While volatility in oil markets might continue, we expect $50-60 Brent toward the end of 2016 which will be supportive for oil exporting countries.

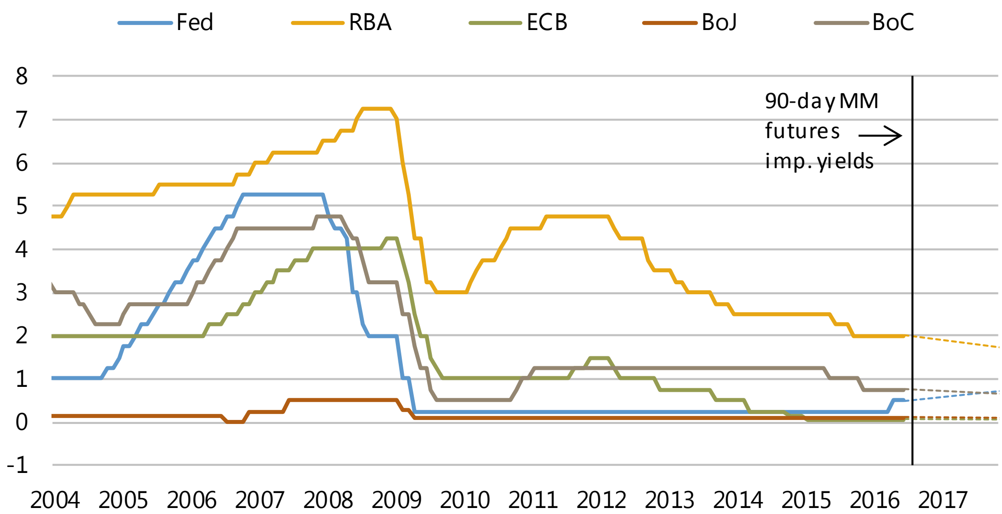


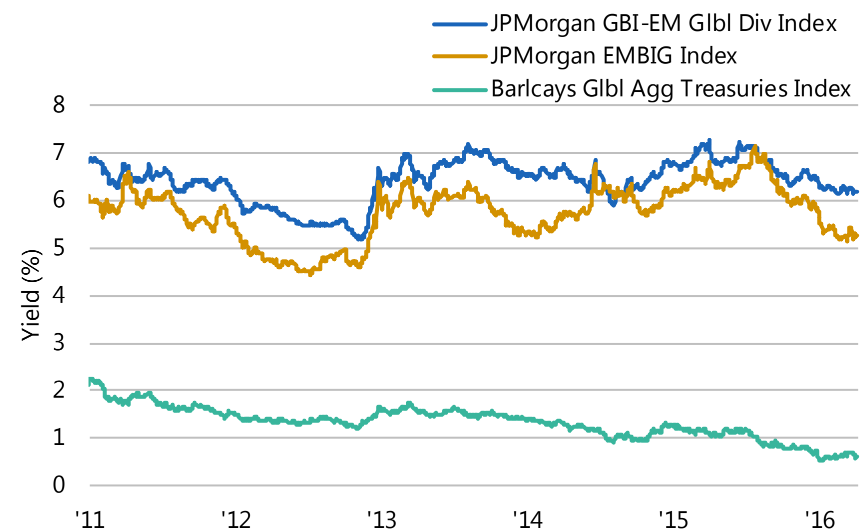




As of 30 September 2016. SOURCE: PIMCO, CSFB
Refer to Appendix for additional outlook and risk information.

# Global central banks' "low for longer" policies are supportive for EM debt

## Central bank policy rates



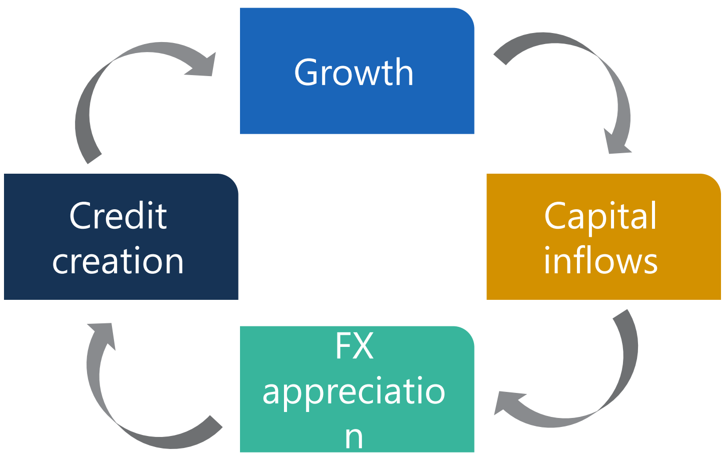

A low/negative developed market yield backdrop—which seems poised to continue—has forced investors to look for yield and carry alternatives further out the risk spectrum

EM's yield advantage relative to Global government bonds remains at widest levels since the global financial crisis

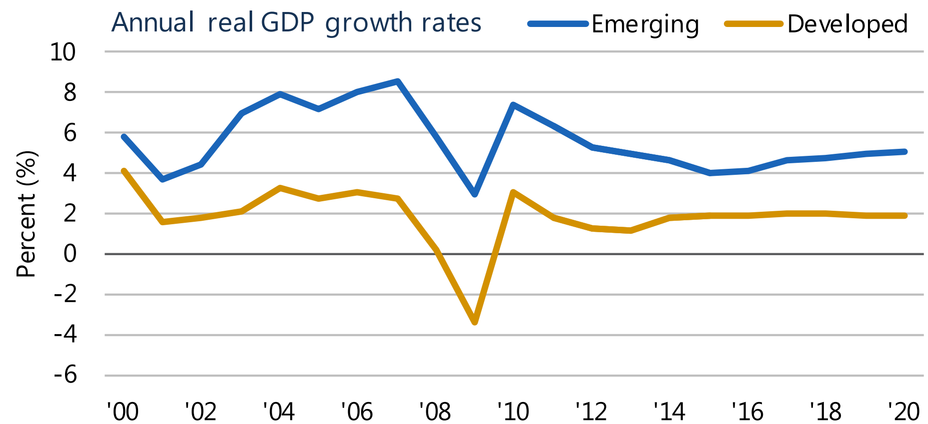
As of 30 August 2016. Right chart as of 30 June 2016
SOURCE: Bloomberg, Barclays, PIMCO
Refer to Appendix for additional forecast, investment strategy, index and risk information.

# Adjustment in financial and economic variables along with shifts in policy mix are bringing EM closer to the "virtuous circle"

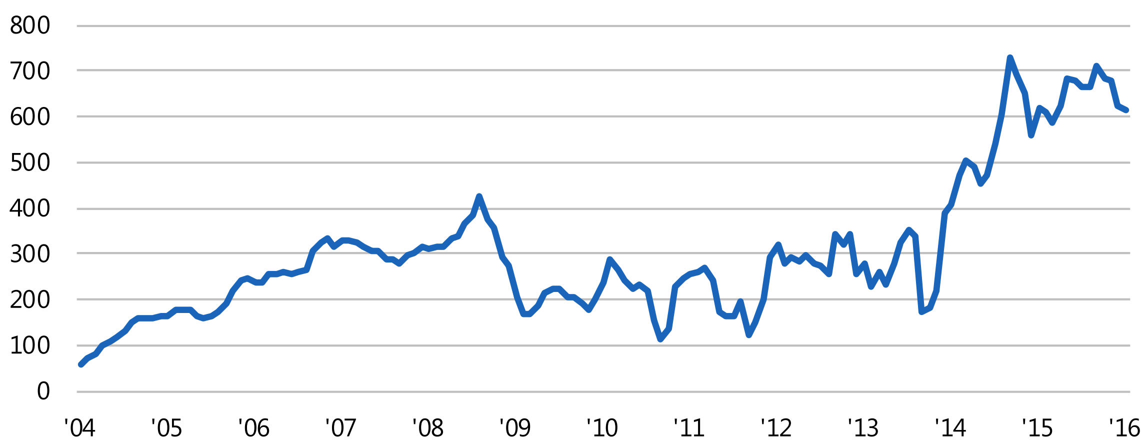
## The "virtuous circle" of EM




## EM-DM growth differentials – widening again



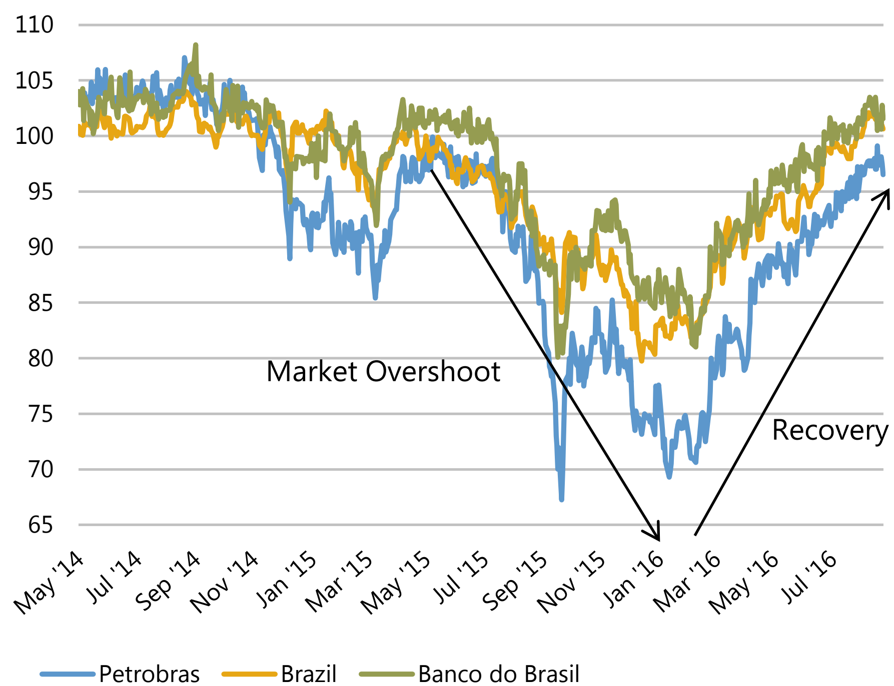

## EM trade balance ($ bn)



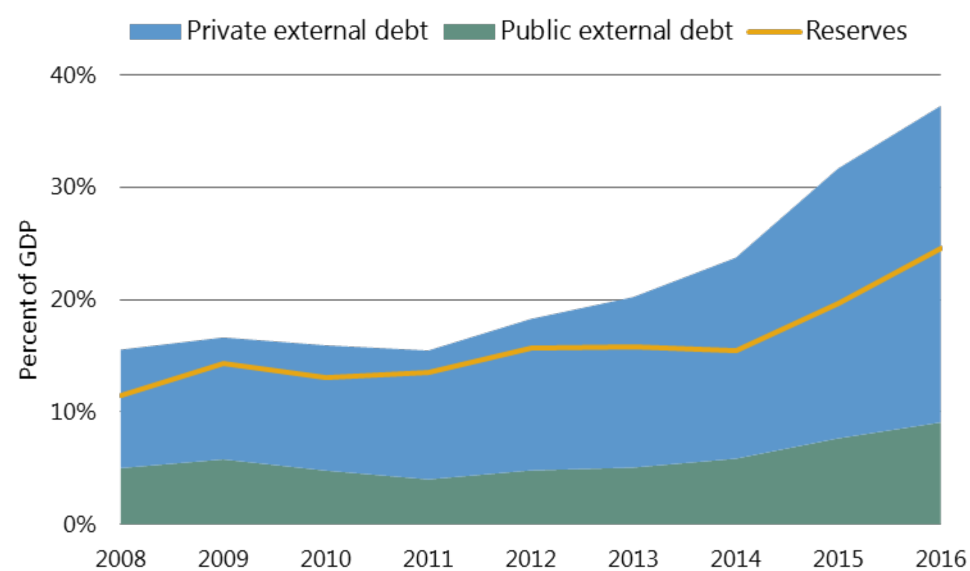

As of 30 June 2016.
SOURCE: PIMCO, Haver Analytics, IMF World Economic Outlook
Refer to Appendix for additional forecast, outlook and risk information.

# Brazil External Debt: Strength of creditworthiness temporarily obscured by political crisis and technical dislocation

**The downdraft caused by messy politics and an agency downgrade in 4Q 2015…**



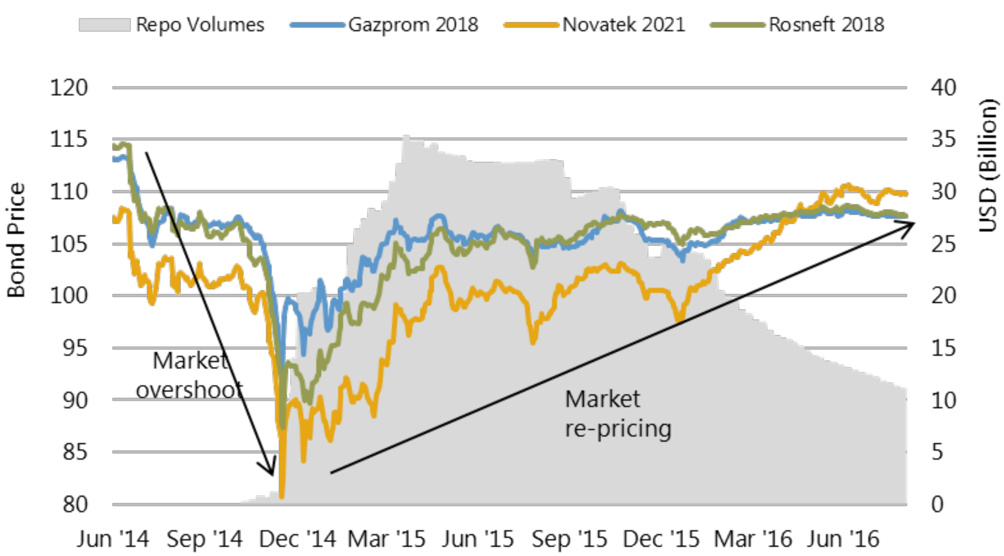

**…temporarily obscured the strength of the sovereign balance sheet**



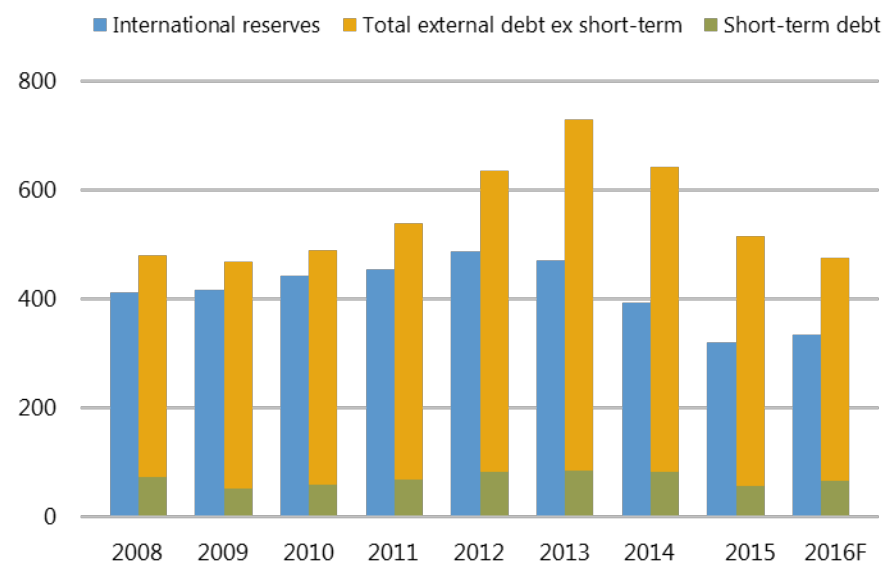

As of 31 August 2016. SOURCE: PIMCO, Bloomberg, Credit Suisse
PIMCO credit research estimates assuming current production curve and FX neutralization through gasoline price hikes
References to specific securities and their issuers are not intended and should not be interpreted as recommendations to purchase, sell or hold such securities
Refer to Appendix for additional investment strategy, issuers and risk information.

# Russia external debt: Strong recovery amid macro-economic adjustments

**Geopolitical stress and a collapse in oil prices caused a sell-off in bond prices…**



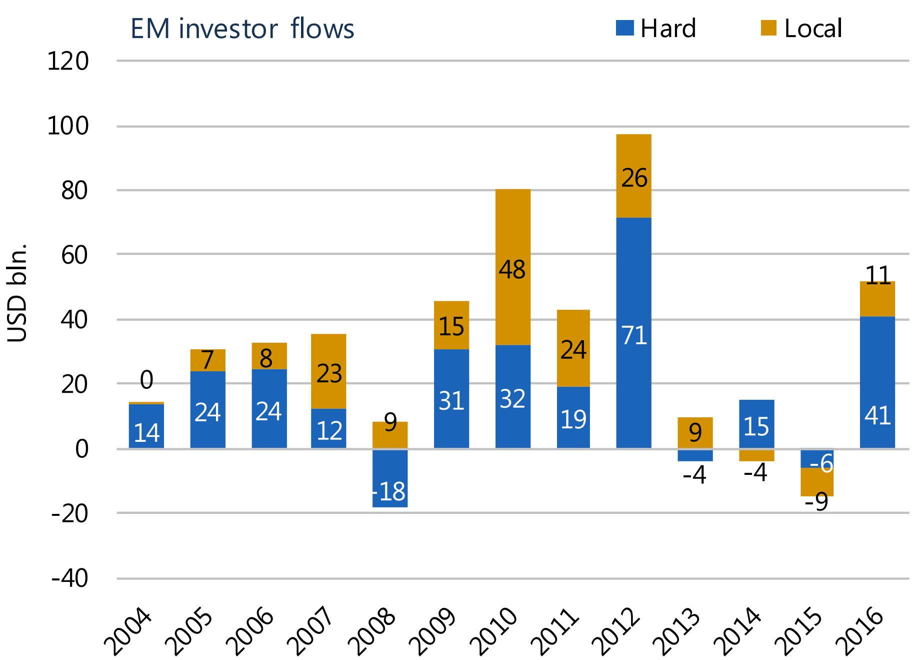

**… however, macro-economic adjustments and utilization of FX reserves supported a repricing**



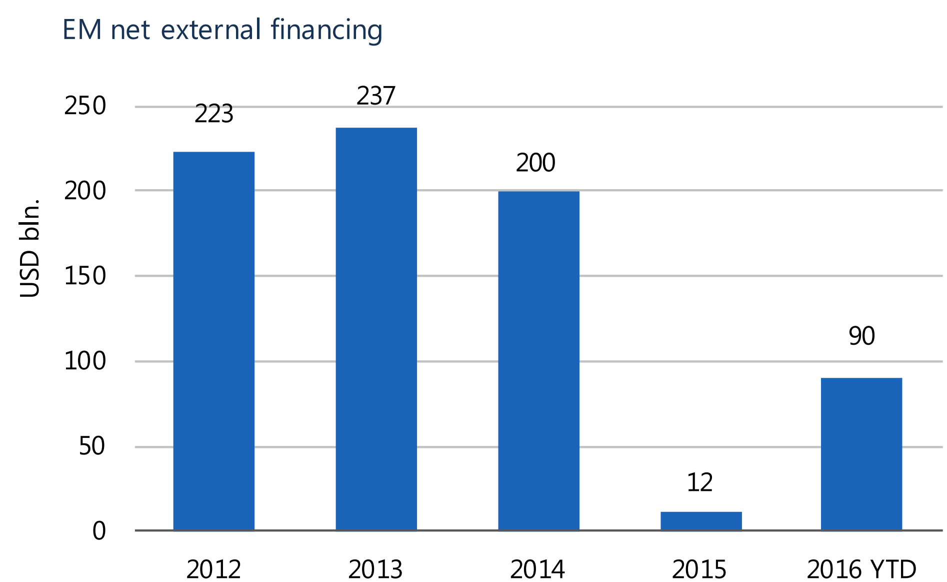

As of 31 August 2016. SOURCE: PIMCO, Bloomberg
PIMCO credit research estimates assuming current production curve and FX neutralization through gasoline price hikes
References to specific securities and their issuers are not intended and should not be interpreted as recommendations to purchase, sell or hold such securities
Refer to Appendix for additional forecast, investment strategy, issuers and risk information.

# Market technicals are more supportive

## Tourist dollars seem to have departed…



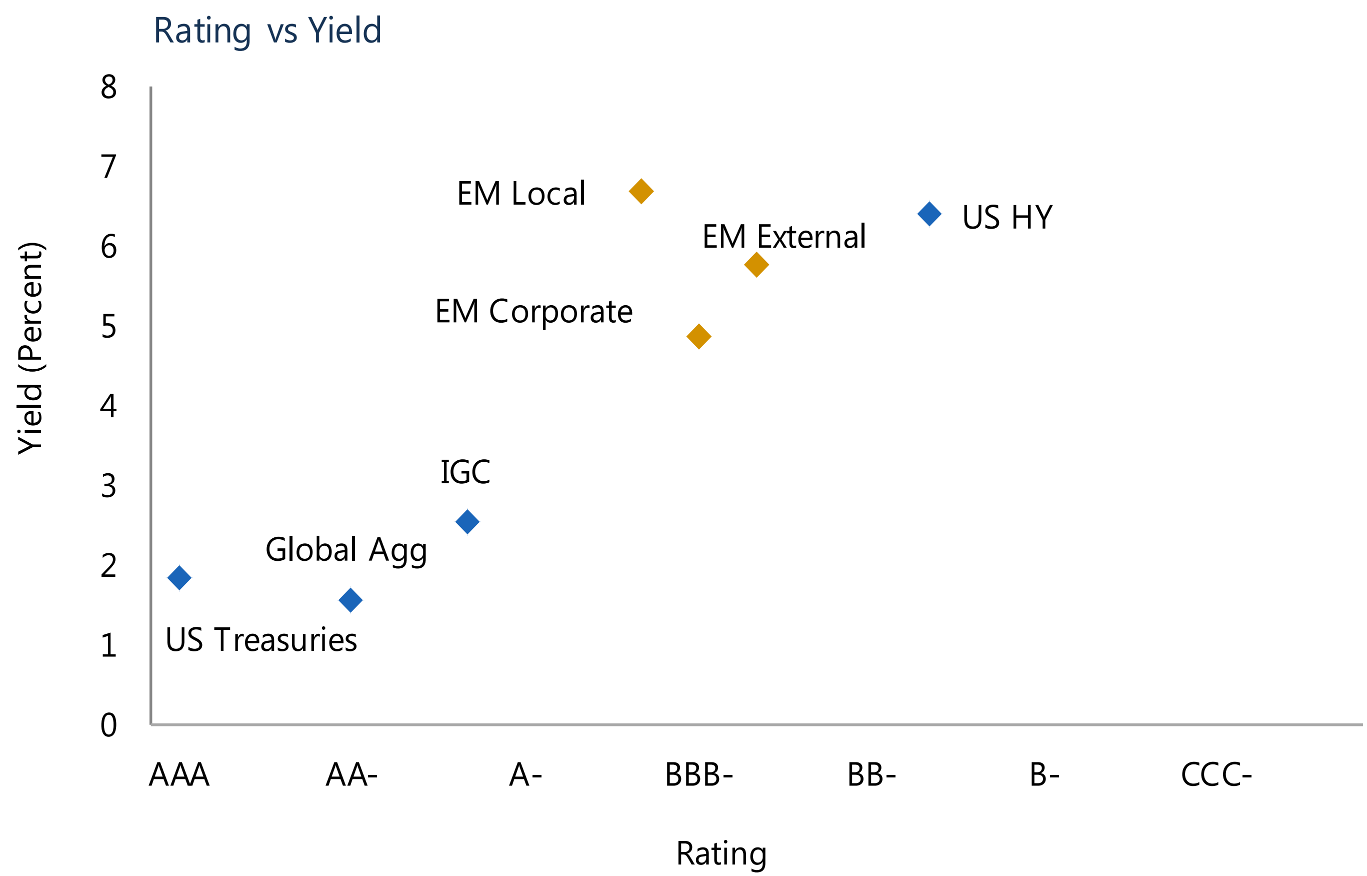

## … while issuance slowed down




**Global investors are generally underinvested in EM, adding support to an asset class that already benefits from lower issuance and overall low global yields.**

As of 30 September 2016.
Issuance in right chart as of 31 March 2016
SOURCE: PIMCO, JP Morgan
Refer to Appendix for additional investment strategy and risk information.

# EM Debt: Valuations are attractive on an absolute and relative basis




As of 30 November 2016
SOURCE: PIMCO, Bloomberg
EM External is represented by the JP Morgan EMBI Global Index, EM Corporate is represented by the JP Morgan CEMBI Diversified Index, EM Local is represented by the JP Morgan GBI-EM Global Diversified Index, IGC is represented by the Barclays Global Aggregate Credit Index, US HY is represented by the BofA ML BB-B Rated US High Yield Index
Global Aggregate is represented by the Barclays Global Aggregate Index and US Treasuries are represented by the Barclays US Aggregate Treasuries Index
Refer to Appendix for additional index and risk information.

# Current valuations combined with EM's carry advantage provide a low hurdle for longer-term outperformance

## JPMorgan EMBIG 5-year breakeven spreads versus fixed income comparators

| | Barclays Aggregate Bond Index | Barclays US Corp IG | BAML US High Yield | US 10Y Bond | Germany 10Y Bund (Currency Hedged) |
|---|---|---|---|---|---|
| **EMBIG Breakeven Spread by Year 5 (bps)** | 728 | 615 | 299 | 747 | 723 |
| **EMBIG Breakeven Spread Change from Current Level (bps)** | 335 | 221 | -95 | 353 | 329 |

At current spreads—which remain wide of the post-GFC average—EM external debt would have to widen significantly to underperform most mainstream fixed income asset classes

As of 31 July 2016
SOURCE: PIMCO, Bloomberg. EMBIG would need to widen by +221 bps to have negative returns vs. US Investment grade (IG)
Refer to Appendix for additional index and risk information.

# EM Local - attractive yields and supportive currency valuations

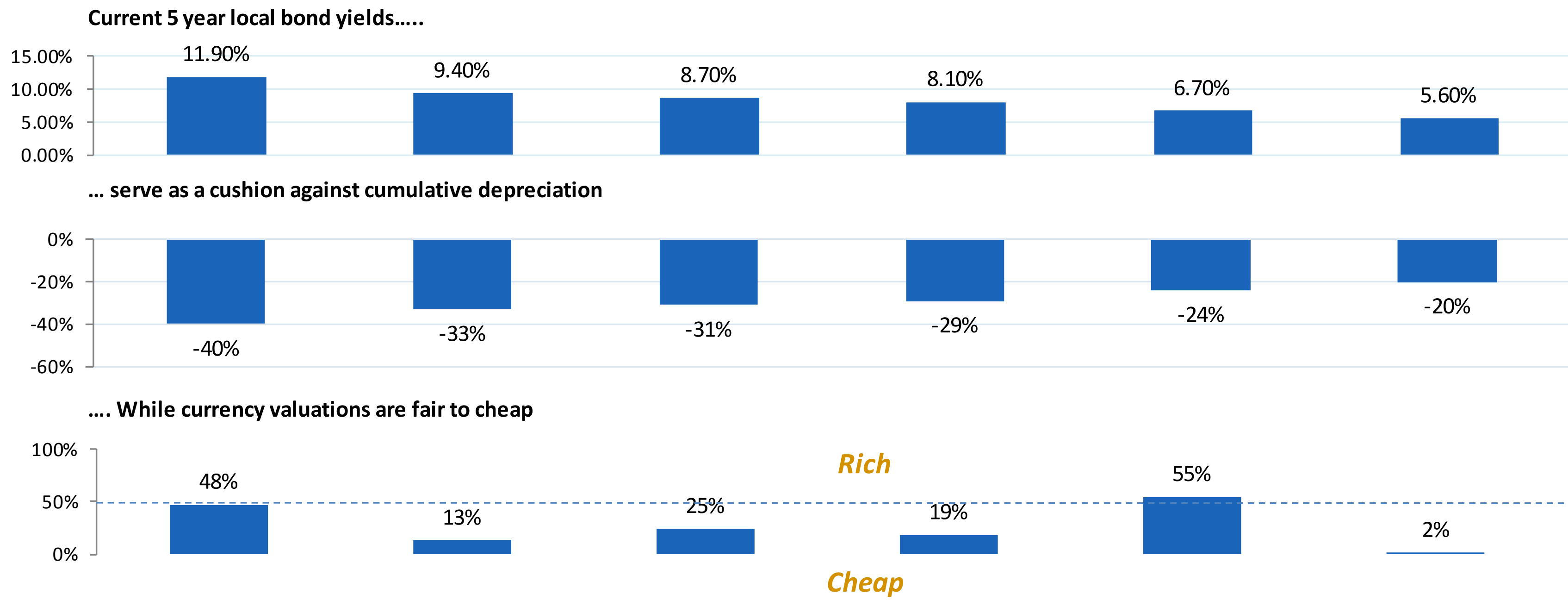
## EM Local bond yields have a cushion against further market weakness

| Country | Brazil | Turkey | Russia | South Africa | Indonesia | Mexico |
|---|---|---|---|---|---|---|

**5 year bond Yield to Maturity**

**Carry cushion against cumalative depreciation**

**Percentile of 5 year REER**




In EM local bonds, the combination of substantial past currency depreciations and high nominal yields provides a significant cushion against underperformance.

As of 31 July 2016
SOURCE: PIMCO, Bloomberg
Refer to Appendix for additional outlook and risk information.

# US Elections: Despite uncertainty, any shift in policy mix seems likely to produce differentiation

**While we still know very little about the President-elect's playbook, EM is likely to be impacted through the following channels:**

- **US fiscal policy** – likely more reflationary/growth oriented; historically good for EM performance
- **Global trade** – a shift toward more protectionist trade policy creates a less EM-friendly backdrop
- **Fed reaction function** – will the inflationary impulse from fiscal stimulus compel a hawkish shift?

**US fiscal expansion combined with...**

| Trade Policy | | Hawkish Fed (USD positive) | Dovish Fed (USD negative) |
|---|---|---|---|
| | **Benign** | **EM Outcome: Mixed, prefer LY** | **EM Outcome: positive** |
| | | Strong external balance sheet, lower exposure to U.S., minimal FX mismatch | Reliance on portfolio flows, higher exposure to global trade cycle |
| | | Winners: Poland, India, Hungary | Winners: Brazil, Mexico, S.Africa |
| | | Losers: Turkey, Colombia, Mexico | Losers: China, Korea, Singapore |
| | **Protectionist** | **EM Outcome: Negative** | **EM Outcome: Mixed, prefer HY** |
| | | Lower debt levels, domestically-oriented economiy, minimal FX mismatch | Strong external balance sheet, lower debt levels, domestically-oriented economy |
| | | Winners: Czech, Korea, Israel | Winners: India, Russia, Turkey |
| | | Losers: Malaysia, China, Mexico | Losers: Malaysia, Singapore, Chile |

SOURCE: PIMCO
HY are sovereigns characterized as higher-yielders; LY are sovereigns characterized as lower-yielders
Refer to Appendix for additional index and risk information.

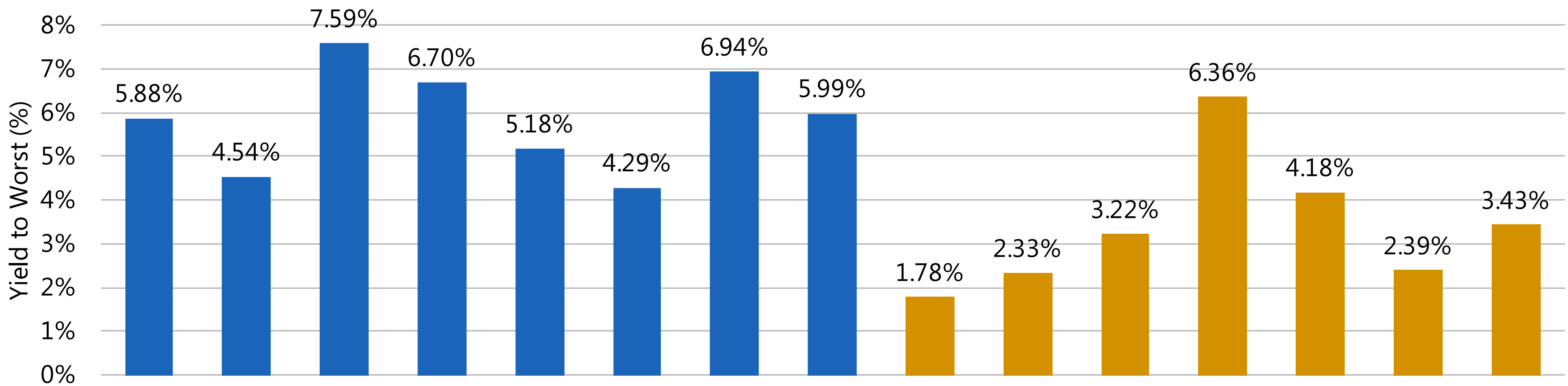
# EM initial conditions: what HAS NOT changed post US election?

| | |
|---|---|
| ***Fundamentals*** | ▪ Improved current accounts due in part to weaker currencies<br>▪ Growth is trending upward in EM |
| ***Technicals*** | ▪ Investors remain underweight EM despite inflows this year<br>▪ Outside the US, monetary policies are likely to remain accommodative |
| ***Valuations*** | ▪ EM yields are still attractive relative to DM alternatives<br>▪ With global developed sovereign yields – particularly in EU/Japan – near zero, investors likely gravitate toward EM |

SOURCE: PIMCO
Refer to appendix for additional investment strategy and risk information.

# EM – At the Cross-Roads of Quality and Yield

## Yields by Asset Class




| | JPM EMBI GLOBAL DIV | JPM EMBI GLOBAL DIV IG | JPM EMBI GLOBAL DIV HY | JPM GBI-EM GLOBAL DIV UNHEDGED | JPM CEMBI BROAD DIV | JPM CEMBI BD IG | JPM CEMBI BD HY | BLENDED EM * | BARCLAYS U.S. TREASURY INDEX | BARCLAYS GLOBAL AGG | U.S. IG | U.S. HY | BANK LOANS | EUR IG FX-Unhedged | EUR HY FX-Unhedged |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **WEIGHTED AVG RATING** | BB+ | BBB | B+ | BBB+ | BBB- | BBB+ | BB- | BBB | AAA | AA | AA | B+ | BB- | AA- | BB- |
| **DURATION (Years)** | 6.54 | 7.39 | 5.63 | 4.86 | 4.68 | 5.19 | 3.92 | 5.26 | 6.01 | 6.51 | 6.60 | 3.72 | 0.43 | 6.71 | 3.23 |
| **SPREAD (bps)** | 361 | 214 | 544 | N/A | 317 | 216 | 511 | N/A | N/A | 46 | 124 | 479 | 383 | 106 | 413 |
| **10-YEAR ANNUALIZED RETURN (%)** | 6.81 | 6.01 | 7.93 | 3.84 | 6.18 | 5.58 | 7.33 | 5.43 | 4.29 | 4.38 | 5.27 | 7.39 | 6.44 | 4.76 | 7.29 |
| **10-YEAR STANDARD DEVIATION (%)** | 8.87 | 7.90 | 10.75 | 13.20 | 8.55 | 6.98 | 14.25 | 10.29 | 4.16 | 2.74 | 5.53 | 10.57 | 10.38 | 3.57 | 12.34 |
| **SHARPE RATIO** | 0.77 | 0.76 | 0.74 | 0.29 | 0.72 | 0.80 | 0.51 | 0.53 | 1.03 | 1.60 | 0.95 | 0.70 | 0.62 | 1.33 | 0.59 |

As of 28 November 2016 * Blended EM Index is 50% JPM GBI-EM Global, 25% JPM EMBIG, 25% JPM CEMBI
SOURCE: JPMorgan, Moody's, Bloomberg, Standard & Poor's.
Refer to Appendix for additional credit quality and index information.

# Key Drivers of Emerging Markets in 2017

***We believe the following factors are key in the EM outlook for 2017:***

## Negative

1. **Higher US Treasuries**
   - spike in yields has bred concerns
2. **Risk of Protectionism**
   - clarity around exact intentions of Trump administration may take several months
3. **Stronger USD**
   - leading to more pressure on EM FX since US election

## Neutral

1. **US Fed**
   - anticipate 2-3 hikes in 2017, unlikely to destabilize markets
2. **Geopolitics**
   - some potential winners like Russia, some countries with potential vulnerabilities like the Baltics
3. **Sovereign Issuance**
   - above 2013-15 levels due to Mid-East issuance but more muted than 2016
4. **Flows**
   - some outflows post-election; unlikely to drive sector returns

## Positive

1. **Commodity rally**
   - oil prices higher on OPEC deal
   - metals higher on China pick-up
2. **Valuations**
   - on the cheap side historically / not impacted by QE
   - EM sovereign spreads about 30 wider vs 2010-16 average, US IG ~45 tighter, US HY ~140 tighter
   - 6% External yields should attract institutional money
3. **Sovereign leverage low (but creeping higher)**
   - hard-currency portion of debt still very low (e.g., ~5% for Brazil)
   - FX devaluation actually protects balance sheets as avoids reserve depletion
4. **Growth**
   - EM vs DM growth differential should widen next year
   - US fiscal spending leads to higher US growth = EM-positive (although EM FX impact unclear)
5. **Positioning clean**
   - investors that exited post-Taper Tantrum have not truly come back

## Conclusions

1. High carry on EM creates high opportunity cost for investors wishing to stay out.
2. Looking for entry points to increase exposure. We hold some dry powder with a bias to add on weakness.
3. Local currency bonds more volatile than hard currency debt, but have also repriced more.
4. EM local remains a more levered bet on EM growth, but offers significantly better risk/return than EM equities.

SOURCE: PIMCO. Refer to Appendix for additional investment strategy and risk information.

# Appendix

**Past performance is not a guarantee or a reliable indicator of future results.**

**CHARTS**
Performance results for certain charts and graphs may be limited by date ranges specified on those charts and graphs; different time periods may produce different results.

**CREDIT QUALITY**
The credit quality of a particular security or group of securities does not ensure the stability or safety of an overall portfolio. The quality ratings of individual issues/issuers are provided to indicate the credit-worthiness of such issues/issuer and generally range from AAA, Aaa, or AAA (highest) to D, C, or D (lowest) for S&P, Moody's, and Fitch respectively.

**FORECASTS**
Forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, as an offer or solicitation, nor as the purchase or sale of any financial instrument. Forecasts and estimates have certain inherent limitations, and unlike an actual performance record, do not reflect actual trading, liquidity constraints, fees, and/or other costs. In addition, references to future results should not be construed as an estimate or promise of results that a client portfolio may achieve.

**INVESTMENT STRATEGIES**
There is no guarantee that these investment strategies will work under all market conditions and each investor should evaluate their ability to invest for a long-term especially during periods of downturn in the market. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown.

**ISSUER**
The issuers referenced are examples of issuers PIMCO considers to be well known and that may fall into the stated sectors. PIMCO may or may not own any securities of the issuers referenced and, if such securities are owned, no representation is being made that such securities will continue to be held.

**OUTLOOK**
Statements concerning financial market trends or portfolio strategies are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.

**RISK**
Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. **Commodities** contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors. Currency rates may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. **Equities** may decline in value due to both real and perceived general market, economic and industry conditions. Investing in **foreign-denominated and/or - domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. **Sovereign securities** are generally backed by the issuing government. Obligations of U.S. government agencies and authorities are supported by varying degrees, but are generally not backed by the full faith of the U.S. government. Portfolios that invest in such securities are not guaranteed and will fluctuate in value. **High yield**, lower-rated securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not.

# Appendix

**INDEX DESCRIPTIONS**

The Barclays Investment Grade Corporate Index is an unmanaged index that is the Corporate component of the U.S. Credit Index. The index includes both corporate and non-corporate sectors and are publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. The corporate sectors are Industrial, Utility, and Finance, which include both U.S. and non-U.S. corporations. The non-corporate sectors are Sovereign, Supranational, Foreign Agency, and Foreign Local Government.

The Barclays Global Treasury Index tracks fixed-rate local currency sovereign debt of investment-grade countries. The index represents the Treasury sector of the Global Aggregate Index.

The Barclays US Credit Investment Grade Index is an unmanaged index comprised of publicly issued U.S. corporate and specified non-U.S. debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. Prior to November 1, 2008, this index was published by Lehman Brothers.

The JPMorgan Emerging Markets Bond Index Global (EMBIG) is an unmanaged index which tracks the total return of U.S.-dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady Bonds, loans, Eurobonds, and local market instruments.

The JPMorgan Corporate Emerging Markets Bond Index (JPM CEMBI) is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging markets entities

JPMorgan Corporate Emerging Markets Bond Index (CEMBI) Diversified is a uniquely-weighted version of the CEMBI index. It limits weights of those index countries with larger corporate debt stocks by only including a specified portion of these countries' eligible current face amounts of debt outstanding. The CEMBI Diversified results in well-distributed, more balanced weightings for countries included in the index. The countries covered in the CEMBI Diversified are identical to those in the CEMBI, which is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging markets entities.

The JPM ELMI+ (JPMorgan Emerging Markets Local Markets Index Plus) tracks total returns for Emerging Markets local-currency-denominated money market instruments. The benchmark instrument of the index is FX forward contracts and these are laddered with maturities ranging from one to three months. Country weights are based on a trade-weighted allocation, with maximum weight of 10% for countries with convertible currencies and 2% for countries with non-convertible currencies. Prior to May 2010, JPMorgan calculated the index return using offer-side prices. Beginning May 2010 JPMorgan began calculating the index return using bid-side FX Spot, Forwards, and LIBOR rates.

JPMorgan Government Bond Index-Emerging Markets Global Diversified Index (Unhedged) is a comprehensive global local emerging markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure.

The BofA Merrill Lynch Global High Yield Constrained Index is an unmanaged index of below-investment grade bonds of corporate issuers domiciled in countries with investment grade foreign currency long-term debt rating (based on a composite of Moody's and S&P). The index includes bonds denominated in U.S. dollars, Canadian dollars, sterling, and euros (or euro legacy currency), but excludes all multi-currency denominated bonds.

It is not possible to invest directly in an unmanaged index.



PIMCO Asia Pte Ltd, 501 Orchard Road, #09-03 Wheelock Place, Singapore 238880, (65) 6491-8000, Registration No. 199804652K