

Economic Review

In his semi-annual testimony to Congress on July 21, Federal Reserve Chairman Ben Bernanke stated that the Federal Open Market Committee (FOMC) expects “continued moderate growth, a gradual decline in the unemployment rate, and subdued inflation over the next several years.” However, due to the weakening economic data, the chairman noted that the “outlook remains unusually uncertain,” and as such, the Committee expects unemployment reduction to be slower and near-term inflation to be lower than originally expected.

Economic releases during the month, specifically consumption-related data, were mostly weak as consumer confidence dropped in July, slipping to 50.4 in July from an upwardly revised 54.3 in June. Additionally, consumer sentiment, as determined by the Reuters’s/University of Michigan’s Consumer sentiment index, plunged in July, down nearly 10 points to a 66.5 reading, far worse than market expectations. Inflation continues to be muted, as the Consumer Price Index (CPI) declined for the third consecutive month, largely due to lower energy costs. CPI dropped by 0.1 percent, matching market expectations. On the housing front, the Housing Market Index reported the weakest conditions since April 2009. Housing starts were also below expectations, down 5.8 percent from a year prior. However, after May’s record plunge of new home sales due to the expiration of the first time homebuyer tax credit, June rebounded 23.6 percent and beat market expectations. Though good news, this latest figure is still down 16.7 percent from a year-ago. Second quarter GDP slowed to an annualized 2.4 percent growth, barely missing analysts’ expectations of 2.5 percent. The jobs picture in June was mixed as temporary Census workers were laid off and private hiring was positive but moderate. The unemployment rate did fall to 9.5 percent in June from 9.7 in May.

Sector Review

■ **Short-Term** – Risk sectors outperformed U.S. Treasuries in July as investors increased their appetite for risk. The market seemed to welcome the positive news from the European bank stress tests which helped move LIBOR lower. Although risk sectors outperformed, the economic environment continues to cast a shadow over the recovery, especially on the employment front. The latest employment report was below expectations with no sign of improvement on the horizon. Front end investors are seeing declining supply levels which is leading to yields moving lower in short maturity paper. 3-month LIBOR ended at 45 basis points which was 8 basis points lower while the LIBOR-OIS spread also moved lower to end at 26 basis points.

- **U.S. Treasury Inflation-Protected Securities (TIPS)** – U.S. TIPS posted modest positive returns as the real yield curve steepened. Shorter maturity TIPS gained amid lower real yields; however, longer maturity issues lost value as real yields rose, weighing on overall TIPS returns. Gains were further limited by negative inflation accruals. In addition, TIPS underperformed their nominal counterparts as breakeven inflation (BEI) levels (measured by the difference between nominal and real yields) narrowed across the entire maturity spectrum.
- **Municipals** – The municipal market posted strong positive performance in July as many investors’ appetite for risk increased. Although risk sectors outperformed U.S. Treasuries for the month, the slow pace of economic recovery is still casting a large shadow over the markets. Most investors were comfortable investing in lower quality municipals which lead them to outperform. Credit selection remains a key factor in investing as we continue to face economic headwinds at the state and local level. Fund flows picked up in July and with a muted supply, helped create a positive tone in the market and lead yields lower. As we move past the first month of the new fiscal year for many states, we continue to see states and local municipalities fail to balance their budgets. Most notably, California and New York have yet to get a complete, balanced budget through to their respective Governors. Most investors are very aware of these situations, however with the below average supply and prospect of increasing taxes, we see many investors continuing to put money to work in the sector. Taxable Build America Bonds (BABs) underperformed both tax exempt municipals and taxable corporates in July, although they outperformed treasuries. AAA GO municipal yields were lower across the curve with 5- and 10-year yields moving lower by 22 and 18 basis points, respectively, while the 30-year yield was lower by 3 basis points. The muni curve steepened over the month with the AAA 2-30 year spread ending at 360 basis points versus 350 basis points last month. Due to the outperformance of municipals versus treasuries, the Muni/Treasury ratios were lower across the curve with the 10-year maturity ending at 88 percent, while the 30-year ratio ended at 99.5 percent using the MMD scale.¹
- **U.S. Treasuries** – The U.S. Treasury curve steepened as shorter maturity rates fell and longer maturity rates rose. The 2-year rate declined by 5 basis points, the 5-year rate declined by 18 basis points, and the 10-year declined 3 basis points. In the long-term U.S. STRIPS market, the 30-year rate rose 18 basis points, and the sector exhibited negative returns over the period.²

- **Mortgage-Backed Securities (MBS)** – Agency MBS outperformed U.S. Treasuries by 45 basis point in July driven by strong foreign and bank demand, benign prepayment reports and low issuance. Refinancing activity remained relatively low in comparison with other periods in which prevailing mortgage rates were far lower than a majority of outstanding supply. Par mortgage rates rallied 22 basis points to finish the month at 3.52 percent while the spread to Treasuries on Agency MBS tightened 10 basis points.³
- **Investment Grade Credit** – In July, the U.S. Investment Grade Credit market returned 1.92 percent, bringing year-to-date returns to 7.65 percent. By the end of July, more than half of the corporations in the S&P 500 have reported 2nd quarter earnings. Results remained strong over the quarter, and earnings per share beat analyst expectations by an average of 7 percent. Additionally, top-line growth has been strong as revenues rose 11 percent for the companies that have reported. Despite positive sentiment resulting from earnings reporting, U.S. economic data have yet to show material improvement. Initial jobless claims were somewhat better than expected, but 2nd quarter GDP disappointed with an estimate of 2.4 percent, below the consensus estimate of 2.6 percent. Consumer confidence, as tracked by the Conference Board, fell to a level of 50.4 from 54.3 in June, below a consensus expectation of a 51.0 level. Corporate issuance in July was strong, as companies continue to take advantage of the low interest rate environment and tighter credit spreads. Issuance rose 14 percent to \$54.9 billion according to JP Morgan. Bucking recent trends, net issuance was \$32.2 billion for July, as financials and industrials issued significantly more debt than what matured or was redeemed. Demand for high quality credit remains robust as evidenced by a 10-year debt issue which came to market in July at the lowest rate for any borrower in the U.S. bond market for the past 15 years. Flows into the asset class have also remained strong as investors reach for yield in response to further Treasury yield declines.⁴
- **High Yield** – High yield bonds managed to post their best month of performance in July since last September, amid a very strong second quarter earnings period. Furthermore, market volatility fell materially, given improved clarity around issues such as financial regulatory reform, the gulf oil spill, and the European bank stress tests, serving as a boon for riskier assets. As speculative grade yields fell over the month by over 75 basis points alongside a modest narrowing of government yields, high yield spreads contracted by about 55 basis points, and stood at 660 basis points by the end of July. While higher risk assets benefited over the

period, this was not necessarily reflected within the high yield market as all quality categories performed in line with each other. Triple-Cs narrowly led the way, up 3.72 percent, followed by double-Bs, up 3.42 percent, and then single-Bs, which finished the month up 3.40 percent. With improved demand and a stronger secondary market, new issuance saw progressive improvement through the month as \$16.5 billion priced, easily topping May and June's combined \$14.1 billion of issuance. The BofA Merrill Lynch High Yield Master II Index was up 3.46 percent for the month outperforming high grade corporates, as represented by the Barclays Capital U.S. Credit Index, by 154 basis points.⁵

- **International** – July was a rare month where prices of bonds, equities, and other risk assets all rose. Yields on most 10-year government bonds continued to fall with most peripheral European government bonds outperforming as spreads narrowed during the month relative to Bunds. Spreads on global corporates and financials narrowed while selective non-agency securities saw modest price appreciation. Currencies continued to see a reversal of May's flight-to-quality as most major currencies outperformed the U.S. dollar.
- **Emerging Markets** – Appetite for emerging markets (EM) amidst lingering developed country creditworthiness concerns helped to drive strong returns in EM in July. Several countries issued new hard currency debt or tapped existing issues as market sentiment improved from previous months. Even though the European bank stress test assumptions and results were questioned by many, the market reaction was broadly positive resulting in a rally towards the end of the month. Emerging Markets debt as measured by the JPM EMBI Global index returned 4.12 percent in July, bringing the year-to-date performance to 9.71 percent. The spread over 10-year U.S. Treasuries tightened by 45 basis points to finish the month at 313 basis points.⁶

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¹ Sources for Yield Data, Fund Flows and Returns are MMD, AMG and Barclays Capital respectively.

² All yield change data sourced from Bloomberg.

³ Performance figures and spread references are as reported by Barclays Capital for the Barclays Capital U.S. Agency Fixed-Rate MBS Index. The Barclays Capital U.S. Agency Fixed-Rate MBS Index outperformed the Barclays U.S. Treasury Index in July on a total return basis.

⁴ Performance figures and spread references are as reported by Barclays Capital for the Barclays Capital U.S. Credit Index and its respective sub-sectors.

⁵ All High Yield performance data included is represented by the various components of the Merrill Lynch High Yield Master II Index.

⁶ EM spreads are shown against a market value weighted average of the spread of every individual issue within the JPM EMBIG index relative to the duration neutral Treasury for each respective issue in the index. The JPM EMBIG outperformed U.S. Treasuries (as measured by the Citigroup Treasury index) for the month.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including the risk that fixed income securities will decline in value because of changes in interest rates; the risk that fund shares could trade at prices other than the net asset value; and the risk that the manager's investment decisions might not produce the desired results. Certain U.S. Government securities are backed by the full faith of the 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. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax; a strategy concentrating in a single or limited number of states is subject to greater risk of adverse economic conditions and regulatory changes. Build America Bonds issued by state and local governments are taxable issues. 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. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio. Diversification does not ensure against risk.

The value of most bond funds and fixed income securities are impacted by changes in interest rates. Bonds and bond funds with longer durations tend to be more sensitive and more volatile than securities with shorter durations; bond prices generally fall as interest rates rise.

ETFs are subject to secondary market trading risks. Shares of an ETF will be listed for trading on an exchange, however, there can be no guarantee that an active trading market for such shares will develop or continue. There can be no guarantee that an ETF's exchange listing or ability to trade its shares will continue or remain unchanged. Shares of an ETF may trade on an exchange at prices at, above or below their most recent NAV. The per share NAV of an ETF is calculated at the end of each business day, and fluctuates with changes in the market value of an ETF's holdings. The trading prices of an ETF's shares fluctuate continuously throughout the trading day based on market supply and demand, which may not correlate to NAV. The trading prices of an ETF's shares may differ significantly from NAV during periods of market volatility, which may, among other factors, lead to an ETF's shares trading at a premium or discount to NAV.

The JPMorgan Emerging Markets Bond Index Global 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 Barclays Capital U.S. Fixed Rate Agency MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates. The BofA Merrill Lynch High Yield Master II Index is an unmanaged index consisting of U.S. dollar denominated bonds that are issued in countries having a BBB3 or higher debt rating with at least one year remaining till maturity. All bonds must have a credit rating below investment grade but not in default. The Barclays Capital U.S. Credit Index is comprised of the U.S. Corporate Index and the non-native currency U.S. Government-Related Index. It is a subset of the U.S. Government/Credit index and the U.S. Aggregate Credit index that consists of publicly issued US corporate, non-US corporate, and specific foreign debentures and secured notes. The index was formerly known as the U.S. Corporate Investment Grade Index and the name change was effective as of 6/1/00 (statistics) and 7/1/00 (returns). The Barclays Capital U.S. Treasury Index is a measure of the public obligations of the U.S. Treasury. The Consumer Price Index (CPI) is an unmanaged index representing the rate of inflation of the U.S. consumer prices as determined by the U.S. Department of Labor Statistics. Barclays Capital 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. Citigroup U.S. Treasury is an unmanaged market index comprising of a universe of U.S. Government Treasury securities. It is not possible to invest directly in an unmanaged index.

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