

Economic Review

Economic data released in the US showed that the economy continued to improve in the first month of 2010, although pockets of weakness remained. The Federal Open Market Committee (FOMC) maintained its target rate for the Fed Funds rate at between 0 to ¼ percent. Interestingly, Thomas M. Hoenig voted against the policy action and expressed his view that “economic and financial conditions had changed sufficiently that the expectation of exceptionally low levels of the federal funds rate for an extended period was no longer warranted”.

Mr. Hoenig’s view was supported by the fourth quarter 2009 GDP data. The economy grew at a 5.74 percent annual rate in the fourth quarter, above consensus estimates of 4.7 percent. The last quarter in which the economy grew this quickly was in the third quarter of 2003 when it experienced growth at a 6.9 percent annual rate. Importantly, consumption growth, driven by improvement in a diverse range of categories, came in higher than estimated. Of the 16 components that make up the broad consumption basket, 13 categories contributed to growth. Furthermore, the Conference Board announced that consumer confidence rose to 55.9 in January from 53.6 in December; economists anticipated a slight drop to 53.5.

The economy does continue to face challenges, however. On the housing front, purchases of new homes fell at a 7.6% annualized rate to 342,000 homes in December from 370,000 homes in November. Construction on new residential buildings fell 4.0 percent to an annual rate of 557,000 homes in December, below estimates for a reading of 572,000 homes. Additionally, employers cut 85,000 jobs from their payrolls in December, falling below estimates following a gain of 4,000 jobs in November. The unemployment rate remained at 10.0 percent, in line with estimates.

Sector Review

■ **Short-Term** – 2010 began with continued low shorter term rates influenced by a low Fed Funds target, quantitative easing measures, and regulation. Although the Fed remains steadfast in keeping the Fed funds rate low for an extended period of time, much of the focus will be on the removal of the various quantitative easing measures that have been implemented since the crisis began. Also of significance was the passage of changes to money market fund regulations by the SEC which should help keep yields low in the front end for some time. Although we have seen industry-wide outflows from money market funds, there remains a large pool of cash from corporations and banks that are looking to put money to work in the short end where we have seen declining supply from most issuers. 3-month LIBOR was unchanged ending at 25 basis points while the LIBOR-OIS spread inched higher ending at 11 basis points. Although

Treasury yields moved lower, spreads also narrowed allowing many spread sectors to outperform.

- **U.S. Treasury Inflation-Protected Securities (TIPS)** – U.S. TIPS gained value as the real yield curve shifted downward. Specifically, short maturity real yields fell more than long maturity real yields. However, long maturity TIPS outperformed short maturity TIPS due their higher duration exposure. Also, relative to nominal U.S. Treasuries, TIPS underperformed overall as breakeven inflation (BEI) levels (measured by the difference between in nominal and real yields) narrowed during the month in most maturities. Non-seasonally adjusted Consumer Price Index (CPI) declined 0.18% for the month, but increased 2.72% for 2009.
- **Municipals** – The municipal market posted positive performance overall, although lower quality sectors outperformed higher quality in January as investors moved down in quality seeking higher yields. Supply in January was manageable as inflows into municipal mutual funds remained steady, extending the trend from 2009. Mutual fund flows in 2009 were almost 3 times the previous record helping the market absorb the large supply.* The uncertainty regarding the future of the Build America Bond program was preliminarily addressed by the President’s proposed budget which included the indefinite extension of the program although at a lower 28% subsidy. Another important change is the addition of not for profit healthcare and issuers funding operations as participants in the program. We expect continued headlines related to budgetary issues at both the state and local levels as we enter the budget season. These headlines could lead to volatility in the municipal market as investors digest each piece of information. AAA GO muni yield only slightly changed across the curve with 5-year yield increasing by 6 basis points, 10-year yield decreasing by 1 basis points, and 30-year yield increasing by 8 basis points. Treasury yield moved meaningfully lower across the curve with the 10-year yield decreasing by 25 basis points and the 30-year yield decreasing by 15 basis points. The muni curve was slightly steeper with the AAA 2-30 year spread increasing to 362 basis points from 357 basis points last month. The muni/Treasury ratio moved higher with the 10-year maturity ending above 80% at 83%, while the 30-year ratio ended at 94% using the MMD scale.
- **U.S. Treasuries** – U.S. Treasury bond performance was positive as a result of a downward shift across the full yield curve. The 2-year rate decreased by 32 bps, the 5-year by 36 bps, and the 10-year by 25 bps, producing greater returns for higher duration segments of the curve. In the long-term STRIPS market, the 30-year rate only decreased by 11 bps, but the inherently high duration of the sector drove considerable, positive returns over the period.

- **Mortgage-Backed Securities** – Agency MBS outperformed Treasuries by 25 basis points in January. The success of the Fed’s Agency MBS Purchase Program has compressed par coupon spreads through pre-crisis levels. In January, the Fed purchased \$50 billion Agency MBS. Since inception, the Fed has purchased \$1.16 trillion of Agency MBS across coupons and this represents approximately 93% of the capacity of the program. Par mortgage rates rallied 20 bps to finish the month at 4.37% while the spread to Treasuries on Agency MBS widened 8 bps.¹
- **Investment Grade Credit** – The investment grade credit market achieved gains in January as favorable liquidity conditions extended the credit market rally. Increased uncertainty in the regulatory and political landscape combined with concerns related to sovereign credit risk potentially influenced a flight-to-quality bias within the corporate bond asset class as investment grade bonds outperformed the high yield market. Risk appetite may also have been challenged by a long-term economic outlook that is unclear, as evidenced by mixed reported data. The index generated a total return of 1.55% for the month of January, up from (-1.00%) in the previous month. Within the high grade sector, BBB spreads tightened 8 basis points, potentially illustrating that although investors remain cautious, they do continue to favor higher spread credits. Despite concerns surrounding weaker European economies, corporate issuers continue to meet little resistance when accessing the private sector market for funding as various methods of financing reemerged with the thawing of the capital markets and companies position themselves for a global recovery. As a result, credits have reduced their issuance needs and pre-funded significant obligations in the near-term.²
- **High Yield** – The high yield market got off to a strong start to begin the New Year, but gave back about a third of the accumulated returns in the final two weeks following macro and political headwinds that detracted from the early January momentum. Nevertheless, high yield bonds managed to finish off January with its eleventh consecutive month of positive performance. Despite the heightened risk aversion in the last weeks, which was visible by the material sell off of equities, the lowest quality bonds within the high yield asset class led the positive thrust for the month once again. Triple-C and lower rated bonds were up 2.40%, outperforming BB and B-rated issues by 105 and 125 basis points, respectively. The drop in speculative grade yields over the month could not keep pace with the decline in government yields, resulting in spreads that were wider by about 15 basis points.³ January saw 48 new deals priced totaling \$20.1 billion, which surpassed the previous record start for a year when \$16.8 billion priced in the first month of 2001. Retail mutual fund inflows remained healthy throughout the month, with a net \$1.4 billion entering the asset class.⁴
- **International** – Economic releases in Europe suggested the eurozone economy is on the mend, though the employment situation remains weak and production indicators volatile. The German IFO Business Climate Survey and Europe-wide Economic Sentiment Indicator both showed improvement, and while the Purchasing Managers Index (PMI) declined modestly it remained above 50 for the 5th consecutive month. Retail sales for Q4 also appeared healthier than previously thought, though unemployment continued to tick higher. The main story in Europe was the growing friction between the core and periphery. Concerns about the ability of peripheral governments to reign in spending and doubts regarding the reliability of government data intensified as revised estimates of 2009 fiscal deficits were significantly higher than previously reported (Greece: 6% of GDP to 12.7%, Portugal: 8% to 9.3%, Spain: 9.5% to 11.4%). With peripheral markets under siege, pressure on the core countries to deliver a plan has become intense. Despite a slightly disappointing 0.1% 4Q GDP (QoQ) growth, UK economic data improved incrementally as unemployment dropped to 7.8% and sales and manufacturing data continued to edge upwards despite missing consensus. A large increase in head-line CPI of 2.9% was primarily due to a decreased in Value Added Tax (VAT) in December 2008, but a letter to the Chancellor of Exchequer might be warranted next month as the higher VAT tax is reinstated in January 2010. Japanese economic data suggested that the incremental recovery maybe petering out. Manufacturing orders are plummeting, and are now at their lowest level since 1987, and with December’s 1.3% yoy drop in CPI the largest yearly decline on record the indications of a demand-led recovery are slim. January PMI dropped to 52.5 from 53.8 last month, and while both the unemployment rate and the job offer-applicants ratio improved in December, both remain awful by historical standards.
- **Emerging Markets** – Heightened risk aversion amidst increasing concerns over the outlook for some European economies along with renewed uncertainty about the impact of regulatory initiatives restrained performance in January. Nonetheless, growth releases continued to suggest a recovery remains intact in many of the emerging economies. This favorable outlook enabled many sovereigns to access international capital markets during the month, resulting in near record issuance in January. Emerging Markets (EM) debt, as measured by the JP Morgan EMBI Global, returned 0.37% in January. EM spreads over comparable maturity U.S. Treasuries widened by 28 bps in January, closing at 323 bps. Despite this widening in spreads, a 25bps decrease in US 10-year Treasury yields helped EM assets performance.⁵

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* Source for fund flows is AMG

¹ 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 underperformed the Barclays US Treasury Index in January on a total return basis.

² Performance figures and spread references are as reported by Barclays Capital for the Barclays Capital U.S. Credit Index and its respective sub-sectors. The Barclays Capital US Credit index underperformed the Barclays US Treasury Index in January on a total return basis.

³ The Spread is represented by the BofA Merrill Lynch High Yield Master II Index over Treasuries. The Index underperformed duration neutral treasuries on a total return basis for the month.

⁴ All High Yield performance data included is represented by the various components of the Merrill Lynch High Yield Master II Index

⁵ 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 underperformed U.S. Treasuries (as measured by the Citigroup Treasury index) for the month.

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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.

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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. The S&P/Case-Shiller Home Price Indices measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan region across the United States. In addition, the S&P/Case-Shiller® U.S. National Home Price Index is a broader composite of single-family home price indices for the nine U.S. Census divisions and is calculated quarterly. There can be no guarantee that the CPI or other indexes will reflect the exact level of inflation at any given time. It is not possible to invest directly in an unmanaged index.

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