

Economic Review

In its March meeting, the Federal Open Market Committee (FOMC) left the federal funds rate unchanged and maintained its position that economic conditions “are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.” The Federal Reserve also announced summary results for stress tests conducted on the capital plans of the 19 largest U.S. bank holding companies, and concluded that 15 of the 19 banks would be able to meet regulatory requirements for capital adequacy, even in an “extremely adverse hypothetical economic scenario.” The headline consumer price index rose 0.4% in February and 2.9% from a year earlier, with a majority of the increase due to rising fuel costs.

U.S. economic data released during March was mostly positive. The Conference Board's index of U.S. leading economic indicators rose 0.7% in February, following a 0.2% gain in January, suggesting an improving outlook for general economic activity in the first half of 2012. February's unemployment rate remained unchanged from January at 8.3%, which is the lowest level since January 2009. Despite rising energy costs, the sustained improvement in labor conditions helped keep consumer confidence near its highest level in the past year and the consumer confidence index fell slightly to 70.2 from 71.6. The ISM non-manufacturing index fell to 56.0 from a one-year high of 57.3 in February, but was still above the average reading for previous economic expansions. Sales of previously owned homes held near an almost two-year high in February, as purchases fell 0.9% to a 4.63 million annual rate, suggesting a gradual recovery in the U.S. housing market. Additionally, housing starts in the U.S. declined 1.1% to a 698,000 annual rate in February, which was in-line with estimates and near their three-year high. As further evidence of stabilization, the decline in home prices continued to decelerate. The S&P Case-Shiller index of property values in 20 cities fell only 3.8% in January from a year earlier, compared to a 4.1% decline in December.

Sector Review

Short-Term – Risk assets rallied in March from positive economic news and over €1 trillion in liquidity provided by the European Central Bank's Long Term Refinancing Operation. However, there was month end volatility from 1) a cut in the annual Chinese growth target for the first time in eight years, and 2) the elevated possibility of a European recession. Expectations for another round of quantitative easing were reduced based on the Federal Reserve's moderately positive statements about growth and inflation.

However, Federal Reserve Chairman Ben Bernanke reiterated his view about the structural headwinds facing U.S. growth, indicating that additional quantitative easing might be on the table in the future. Other developed world central banks announced that they would keep interest rates on hold due to the slow economic climate. Prime money market funds began to increase their Eurozone holdings, most noticeably in exposure to French banks, despite the fact that liquidity continues to be the priority for these funds. LIBOR continued to trend downwards indicating an increase in liquidity. General Collateral (GC) repo rates trended higher due to added Treasury bill supply and the risk-on appetite of investors, although this trend reversed moderately at the end of the month as investors held onto collateral over quarter end.

U.S. Treasury Inflation-Protected Securities (TIPS) – In the U.S., real yields moved higher following the FOMC statement which failed to confirm any imminent balance sheet increases. However, TIPS outperformed their nominal counterparts amid wider breakeven inflation (BEI) levels in the intermediate and longer dated maturities.

Municipals – After several months of strong performance, municipal market returns retreated in the month of March, driven by a high volume of supply from issuers incentivized to come to market at low rates. March new-issue volume was \$34.5 billion, up 31% from February, and 82.5% higher than March 2011. Refunding transactions continued to drive supply, as approximately 57% of new issue volume year-to-date has been comprised of refunding deals (refinancing existing debt, as opposed to new money issuance). Mutual fund flows have been positive through the month, albeit somewhat diminished from the strong January and February levels. Investors continue to show a strong appetite for higher-yielding securities amidst a dearth of supply in the sector, which has led to significant outperformance of high-yield municipal securities during the month.

Tax-exempt and taxable municipal returns were predominantly negative in the month of March. The Barclay's Municipal Bond Index fell 0.65%, the Barclays 1-10 year Municipal Bond Index fell 0.56% and the Barclays Long Municipal Bond Index fell 0.29%. In contrast, the Barclays High Yield Municipal Bond Index returned 0.82%. From a municipal yield curve perspective, the 2-30 year spread increased by 0.06% to 3.03%. AAA-rated yields changed by 0.10%, 0.26%, and 0.16% month-over-month in the 2, 10, and 30-year maturities, to 0.36%, 2.11%, and 3.39%, respectively. The 10-year municipal/treasury yield ratio rose slightly from 94% at the end of February to 95.5% at the end of March, and the 30-year ratio rose to 105% from 102% during the month, using the MMD AAA Scale.¹

High Yield – U.S. high yield corporate bonds were nearly flat in March, with total returns of -0.09%, following strong performance in January and February, which saw total returns of 2.9% and 2.3%, respectively. This brings returns for the first quarter to 5.15%. The higher quality segment within high yield (HY) underperformed in March with BBs returning -0.45% and Bs -0.01%, while CCCs gained 0.66%, as the BB segment is more subject to losses in a rising rate environment given relatively longer duration. High yield outperformed U.S. investment grade corporates in March which returned -0.79% as represented by the Barclays U.S. Credit Index, but underperformed equities (3.29%) as represented by the S&P 500. For the quarter, HY outperformed U.S. investment grade as well which returned 2.04%. In March, European HY outperformed U.S. HY, returning 1.27% largely due to the lack of exposure to U.S. Treasuries, bringing returns of 12.58% for the quarter.

Spreads ended the month at 5.99%, 0.01% wider since the end of February and 1.24% tighter since year end 2011. HY bond yields increased to 7.23%, 0.19% higher relative to the end of the prior month though still roughly 1.00% lower since year end. Within high yield, the best performing sectors were higher beta, which is generally lower duration, including real estate, banking, gaming, and consumer-cyclical. On the contrary, the worst performing sectors were lower beta such as

utilities, automotive, and media cable. Metals and mining in particular underperformed due to lower growth expectations in Asia, which has a large impact on metals and a poor outlook on U.S. coal with reduced demand for thermal coal due to competition from natural gas and environmental regulation.²

Investment Grade Credit – In March, the U.S. Investment Grade Credit Index returned -0.79%. Investment grade credit spreads narrowed and yields rose 0.11% to 3.21%, as represented by the Barclay's Capital U.S. Credit Index.

Investment grade credit outperformed like-duration Treasuries again in March, although after reaching a year-to-date tight on March 19, the U.S. Investment Grade Corporate Index has mostly widened. In contrast, Treasuries have recently been rallying and retraced a significant portion of the move higher in yields; after reaching 2.40% on March 20, 10 year yields had declined nearly 0.25% as of month end. Credit markets rallied after remarks made by Federal Reserve Chairman Bernanke at the NABE's Annual Conference were viewed as increasing the likelihood of QE3. However, since then, credit markets have largely pulled back as a combination of lackluster high frequency economic data in the U.S., weakness in European markets and continued underperformance in China weighed on risk assets.³

U.S. Treasuries – U.S. Treasuries exhibited negative performance as rates rose across the curve. The 2-year rate rose nearly 0.04%, the 5-year rate rose 0.18%, and the 10-year rate rose 0.24%. In the long-term U.S. STRIPS market, the 30-year rate rose 0.26%, and the sector exhibited negative returns over the period.⁴

Mortgage-Backed Securities (MBS) – Agency MBS outperformed Treasuries in March. Higher coupons outperformed lower coupons, as expectations regarding QE3 continued to decline. Fannie Mae par mortgage rates increased 0.20% to finish the month at 3.09%. GNMA coupons were volatile during the month, before ending the month relatively in line with conventional MBS. Gross issuance totaled \$135.8 billion across fixed-rate products in February, a large increase of \$33.4 billion over the previous month. This was likely due to shorter closing times on loans before the 0.10% Guarantee Fee increase, which went into

effect in April. MBS valuations continue to be impacted by QE3 expectations and broader housing policy initiatives. Prepayment speeds continued to increase as HARP 2.0 changes were implemented. Based on Freddie Mac loan level data, increases in speeds have primarily come from higher LTV loans for HARP-eligible cohorts.⁵

International – As sentiment turned sharply in mid-March, with the sugar high wearing off and reality setting in, financial markets were mixed over the month. Risk assets soared into March only to come back to earth by month-end, erasing most of their gains. However, clear signs of divergence emerged as economic strength in the U.S. persisted and expectations of an imminent need for further quantitative easing were pushed out. The S&P 500 strengthened again over the month, while U.S. Treasuries sold-off in a bear-steepener.

In the eurozone, German bunds ended the month flat with peripheral sovereign spreads against bunds mixed as investors started to target the next potential crisis; notably, the Spanish 10-yr spread widened. Across the channel, U.K. Gilts sold-off across the curve despite the Bank of England's £50 billion expansion of its asset purchase program ("QE3"). Most other developed sovereign bonds remained flat on the month.

Emerging Markets (EM) – March provided a period of consolidation for EM assets following the strong returns seen in January and February. The stream of constructive economic data in the U.S. continued, producing higher U.S. Treasury yields. However, this contrasted with the uncertainty around Greece's progress in restructuring its debt and Spain's budgetary challenges which reminded investors that the lingering issues in Europe have neither easy nor quick answers. Returns for emerging market sovereign and corporate debt denominated in U.S. dollars were roughly flat during March as the combination of carry and spread compression just barely offset the rise in underlying risk-free rates. In local space, slightly weaker currencies and rising yields both contributed to negative performance during the month.

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¹ Sources for yield data and returns are Thomson Municipal Market Data (MMD) and Barclays respectively. The yield consists of all general obligation municipal bonds issued in the United States with 30 years remaining to maturity, which have been rated in the highest rating category by a Nationally Recognized Statistical Rating Organization.

² All High Yield performance data included is represented by the various components of the Merrill Lynch High Yield Master II Index.

³ All performance figures, credit ratings and spread references are as reported by Barclays for the Barclays U.S. Credit Index and its respective sub-sectors.

⁴ All yield change data sourced from Bloomberg.

⁵ Agency MBS and Treasury performance as reported by Barclays.

A word about risk: 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 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. There can be no guarantee that the CPI or other indexes will reflect the exact level of inflation at any given time. Barclays Long Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. The Barclays Municipal Bond Index consists of a broad selection of investment-grade general obligation and revenue bonds of maturities ranging from one year to 30 years. It is representative of the tax-exempt bond market. The index is made up of all investment-grade municipal bonds issued after 12/31/90 having a remaining maturity of at least one year. The Barclays 1-10 Year Municipal Bond Index is an unmanaged index considered to be generally representative of investment-grade municipal issues having remaining maturities from 1-10 years and a national scope. The Barclays High Yield Index is an unmanaged market-weighted index including only SEC registered and 144(a) securities with fixed (non-variable) coupons. All bonds must have an outstanding principal of \$100 million or greater, a remaining maturity of at least one year, a rating of below investment grade and a U.S. Dollar denomination. Barclays U.S. Credit 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. The S&P 500 Index is an unmanaged market index generally considered representative of the stock market as a whole. The index focuses on the Large-Cap segment of the U.S. equities market. The BofA Merrill Lynch High Yield Master II Index is an unmanaged index consisting of U.S. dollar denominated bonds that are rated BB1/BB+ or lower, but not currently in default. 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 Institute of Supply Management (ISM) Non-Manufacturing Index is based on surveys of more than 400 non-manufacturing firms' purchasing and supply executives, within 60 sectors across the nation. The index is weighted according to industry contribution to GDP and is calculated using 50% as the centerline between positive and negative expectations. It is not possible to invest directly in an unmanaged index.

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