PIMCO

Asset Allocation
Secular Outlook 2015

Asset Allocation Without Tailwinds

The global economy and markets have come a long way since the financial crisis. Output in most major economies (in nominal terms) is higher than it was pre-crisis, as are asset prices. The specter of deflation is starting to fade as economic slack decreases and commodity prices stabilize. Extraordinary central bank policies, while controversial, have played a significant role in getting us here.

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Looking forward, it is our view that the world remains in The New Neutral, and importantly that asset markets now broadly reflect this development in their prices.

All this has significant ramifications for the evolution of asset prices and for how investors should approach multi-asset portfolios over the next three to five years, which we refer to as the secular horizon.

We reaffirmed the New Neutral thesis in May, when our investment professionals from across the globe gathered in Newport Beach for our Secular Forum to debate the long-term outlook for the global economy and to identify and assess key variables, trends and catalysts that may affect valuations and returns across global asset classes. We came away from the forum with some important insights, which Daniel Ivascyn, Richard Clarida and Andrew Balls describe in PIMCO's *Secular Outlook,* "The New Neutral Revisited."

At the center of our New Neutral thesis is the belief that even as central banks raise rates, they will do so slowly and prudently, and that the neutral rate over the coming cycle – meaning a rate that is neither stimulative nor contractionary – will be lower than in cycles past (a rough benchmark for the U.S. is closer to a 2% average policy rate than the traditional 4% assumed by many). We also don't foresee an inflation problem, even as we move away from an era of extremely limited price increases. Low interest rates and moderate inflation together support a muted but prolonged business cycle, and we believe this combination helps to sustain current asset valuations.

So why does our New Neutral thesis have significant ramifications for multi-asset investors over the secular horizon? We would argue that the tailwind from ever-lower policy rates and contracting term premia witnessed over the past 30 years is largely past us. Moreover, current valuations – as most assets already price in the reality of lower rates – are likely to constrain potential returns going forward.

Therefore investors must adjust to a world where returns on asset classes and the paradigm for constructing optimal portfolios over the next five years are unlikely to resemble those of the last five or even 30 years. Investors will need to be more dynamic and tactical in their overall asset allocations, and they should approach portfolio construction with even more differentiation as they allocate risk to individual positions. It is still possible to achieve compelling returns, but we believe the role of active portfolio management has become more important, and more necessary, than ever.

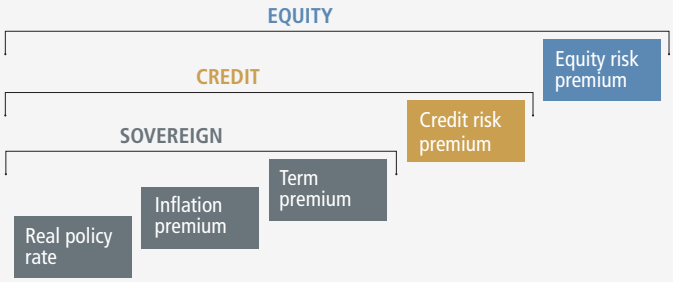
The New Neutral

For the next three to five years, even as monetary policymakers seek to normalize interest rates they will generally set short-term rates at levels below the rates that prevailed before the global financial crisis. Also in this New Neutral world, countries will converge to slower trend growth trajectories. Since PIMCO introduced The New Neutral secular view in May 2014, the construct has been priced in to financial markets.

LOWER DISCOUNT RATES SUPPORT VALUATIONS

Lower discount rates increase valuations

Building blocks of the discount rate



The fading discount rate boost

Let's start with restating the essential point: **The tailwind to asset classes from ever-lower interest rates is largely behind us**. Over the past several years, lower risk-free rates from aggressive central bank policies accompanied by dropping inflation created a "denominator effect" by pushing discount rates lower, which in turn led to higher valuations of assets. The discount rate applicable to future cash flows, regardless of the asset class, starts with the real "risk-free rate." The appropriate discount rate for each asset class can be modeled as the risk-free rate with an additional risk premium associated with its position in the capital structure and exposures to risk factors: for example, inflation and term premia for sovereign bonds, default and liquidity premia for credit, and equity risk premium for equities – each building off the risk-free discount rate. As risk-free rates drifted lower over a period of many decades, not only did the present value of future cash flows increase in the sovereign bond market, valuations increased broadly across **all** asset classes as growth expectations declined by less than the drop in risk-free rates.

So where are we headed? In fixed income, we do not see significantly higher bond yields over the next three to five years. Rather, policy rates are expected to rise gradually over the secular horizon. This change, from steadily falling discount rates to stable or, in many cases, modestly rising discount rates, will likely have substantial consequences: first, via lower expected returns, and second, on portfolio construction.

In this new regime, rigid "buy-and-hold" strategies may not work as well as they did in the past. A prime example is the recently popularized *"risk parity"* approach to asset allocation, a strategy by which portfolio allocations are sized in order to ensure the risk contribution from stocks, bonds and inflation-related assets is equal, or at parity. Given bonds generally have lower volatility than stocks and other assets, risk parity strategies systematically use leverage to increase risk exposure to the bond component. Over the past several years, markets have been generally friendly to these strategies as bond term premia compressed and volatility became subdued. However, they may now face headwinds as volatility resets and interest rate trends reverse, necessitating an active approach when managing these strategies. Moreover, studies have shown that the negative correlation between stocks and bonds (one of the key tenets behind this approach) tends to be greater when yields are falling than when yields are rising, which has significant implications for portfolio construction and diversification.

It seems clear that in the market environment we are facing, **tactical asset allocation and robust portfolio construction will become even more important as correlations become increasingly unstable and dispersion increases across asset class returns.** In this new regime, region, country and sector selection and bottom-up relative value strategies will have to do more of the heavy lifting to help offset either the end or reversal of the tailwind of declining discount rates.

Forecasting long-term returns

If asset valuations are full and price returns are likely to be lower overall, where do we find attractive opportunities? The New Neutral hypothesis offers a guide. Weaker growth potential and waning tailwinds from demographic trends will likely incentivize central bankers of highly levered, developed economies to raise rates in a slow and prudent manner, not veering far from the zero bound and keeping policy rates below previous long-term averages. We believe this will contribute to a longer economic cycle.

In this scenario, investors should expect low but positive returns from most developed market asset classes, with equities and credit outperforming government bonds and cash. Therefore, despite corporate bond yields seeming low and equity multiples seeming high, we do not see either market as overvalued or primed for a lasting correction. Investors may wish to add emphasis to the riskier asset classes in their overall allocation given our belief that lower yields and higher valuation multiples should be viewed through the lens that rates will be lower than in previous decades even as they creep upward.

For example, as we consider equities in our asset allocation portfolios, we estimate the current equity risk premium in the U.S. to be 3.9% in real terms, which is very close to its long-term average of 4.0% and higher than the 3.5% average observed during economic expansions. This suggests a fair premium relative to U.S. bonds and one with room to compress as economic strength continues to improve. Moreover, in seeking to outperform, one can always look for companies, sectors or even countries where earnings growth can positively impact prices and valuations.

Next, consider U.S. investment grade credit: Spreads relative to U.S. Treasuries, a measure that shows the additional premium bond investors demand as compensation for default risk, are not especially narrow relative to history, particularly for this stage of the business cycle. The current spread over the risk-free rate (option-adjusted spread, or OAS) is 137 basis points (bps), slightly narrower than the 40-year average of 138 bps but wider than levels typically observed during economic expansions (132 bps on average in first half expansions, and 110 bps on average in second half expansions).

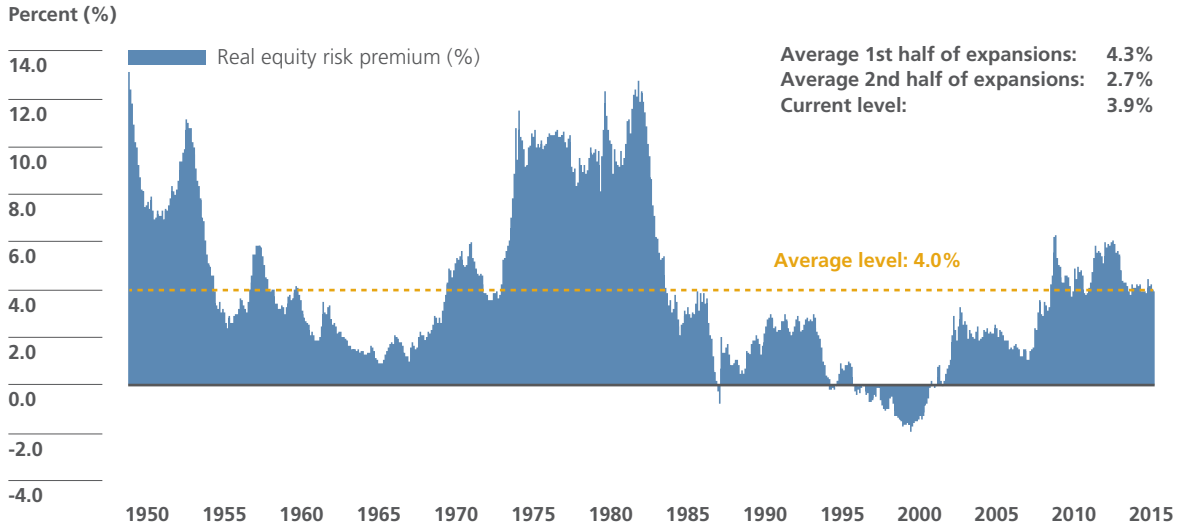
For global markets, our general estimates for long-term returns based upon our New Neutral thesis are shown on page 6. These estimates take into account current valuations, carry and where we believe valuations may be headed based upon our macroeconomic outlook.

Turning to emerging markets (EM), we believe that on average these sectors should outperform comparable developed market sectors over the secular horizon, but are likely to do so with higher volatility and other risks that must be considered.

As in the developed markets, lower yields have been a tremendous supporter of performance for EM assets following the financial crisis. However, in the past few years, emerging markets have gone through numerous challenges that have led to generally disappointing performance. Lower growth, lower commodity prices, weak exports and a strong U.S. dollar recently have been serious headwinds. The silver lining of the recent challenges, however, is that EM assets generally offer more favorable starting valuations.

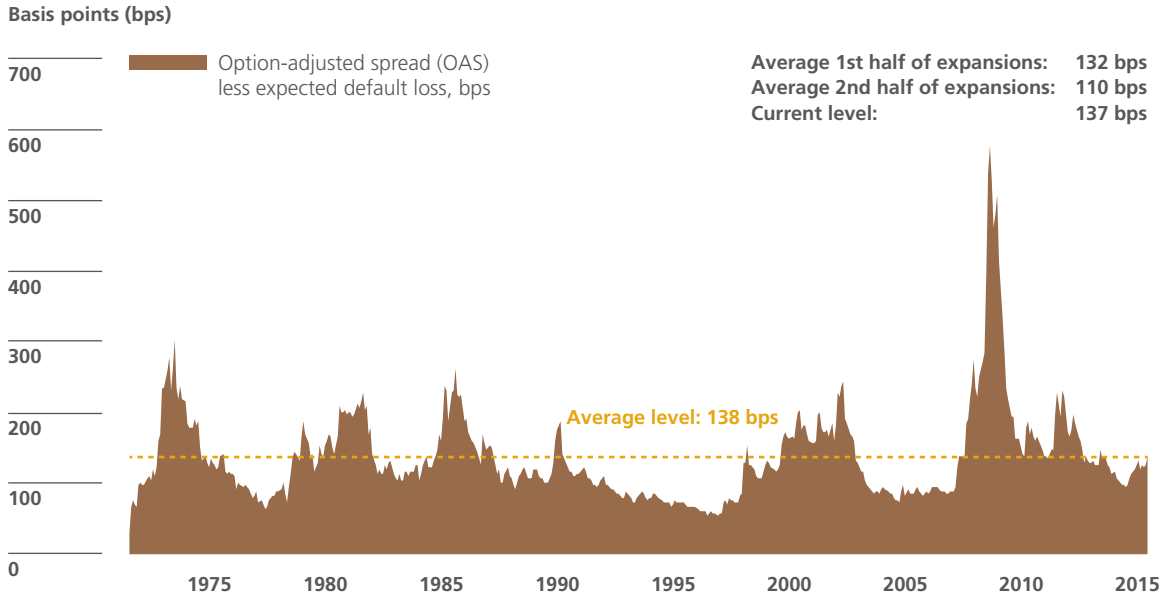
EM growth, which is expected to be higher than in developed markets, also helps valuations appear attractive. Add in the higher level of investments and productivity enhancements, and we have a favorable backdrop for attractive secular returns from emerging markets.

U.S. REAL EQUITY RISK PREMIUM SUGGESTS ATTRACTIVE LONG-TERM RETURN POTENTIAL IN EQUITIES



Source: Robert Shiller, Yale database, Bloomberg, PIMCO as of 30 June 2015
Hypothetical example for illustrative purposes only. Equity Risk Premium (ERP) = S&P500 cyclically adjusted earnings yield (inverse of the cyclically adjusted P/E) – 10-year real rate. 10-year real rate uses 10-year TIPS yield since 1998 and 10-year nominal rates less 36-month trailing inflation for periods before 1998. Expansions are defined based upon NBER business cycle data. First and second halves are equal halves of the full expansion period per this data; e.g., a hypothetical 20-month expansion would be sub-sampled by using the first 10 months as the first half and the second 10 months as the second half.

U.S. CREDIT VALUATIONS APPEAR FAIR RELATIVE TO LONG-TERM LEVELS



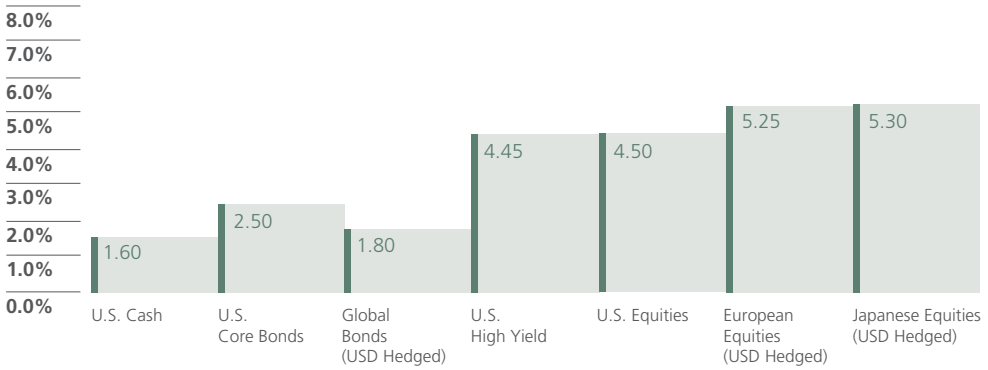
Source: Barclays U.S. Investment Grade Credit Index as of 30 June 2015. The option-adjusted spread (OAS) measures the spread over a variety of possible interest rate paths. The OAS measures the average return an investor will earn over Treasury returns, taking all possible future interest rate scenarios into account. From 1973 to 1990 OAS is computed from the duration-matched yield-to-worst of the Barclays IG Credit Index and Barclays Treasury Index. Starting in 1990 the OAS data is provided by Barclays. OAS was adjusted to maintain a constant ratings distribution.

Thus far we have described the likely impact of The New Neutral on asset prices and their forward return potential, but as we mentioned at the outset, it is imperative to survey the markets and identify pockets of potentially more attractively priced securities that may deliver more attractive risk/return tradeoffs. In developed markets, to name a few examples, we believe global equities outside of the U.S. offer better forward return potential than those within. Across credit sectors we see superior opportunities in European financial and U.S. housing sectors. With respect to government debt, we generally find inflation-linked securities more attractive than their nominal counterparts.

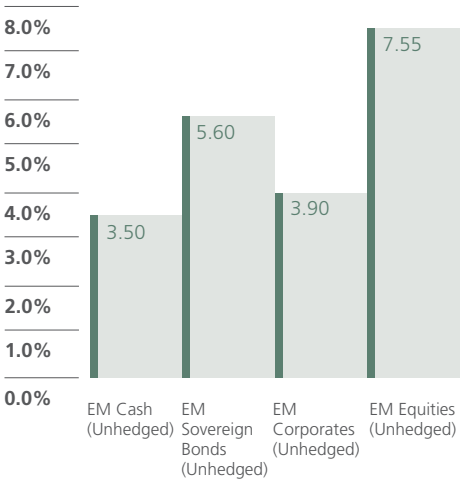
In EM, our theme of differentiation and dynamic management of portfolio positioning is even more important. No single EM country or asset class is likely to deliver these "average" long-term returns. Secular winners and losers will be decided as a function of initial conditions as well as country-specific monetary and fiscal policies. For countries or companies in emerging markets to attract scarcer global capital, they will need to demonstrate superior return potential that helps to compensate for their lack of liquidity and greater volatility. Policymakers and corporate managers will need to take the steps necessary to lead their countries and companies toward sustainable economic expansion. Successful investors will have to work to identify these potential winners: In the New Neutral world of muted growth, the twin engines of export-driven growth or terms-of-trade shock may not work going forward.

10-YEAR RETURN ESTIMATES

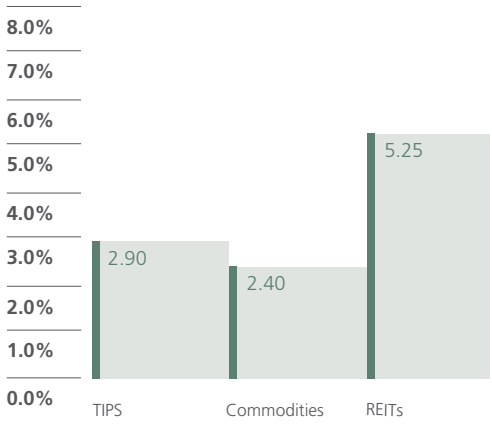
DEVELOPED MARKETS



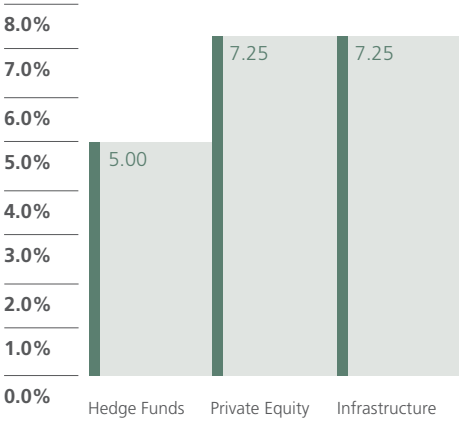
EMERGING MARKETS



REAL ASSETS



PRIVATE STRATEGIES/ILLIQUIDS



Source: PIMCO as of 31 March 2015. Estimates are based on the following indexes: U.S. cash – Citi 3-Month Treasury Bill Index; U.S. core bonds – Barclays U.S. Aggregate Index; global bonds (USD-hedged) – Barclays Global Aggregate ex USD Index; U.S. high yield – Barclays U.S. High Yield Index; U.S. equities – S&P 500 Index; European equities (USD-hedged) – MSCI Europe Index; Japanese equities (USD-hedged) – MSCI Japan Index; EM cash (unhedged) – J.P. Morgan ELMI + Unhedged Index; EM sovereign bonds (unhedged) – J.P. Morgan GBI-EM Global Index; EM corporates (unhedged) – J.P. Morgan CEMBI Diversified Index; EM equities (unhedged) – MSCI Emerging Markets Index; TIPS (U.S. Treasury Inflation-Protected Securities) – Barclays U.S. TIPS Index; commodities – Bloomberg Commodity TR Index; REITs (real estate investment trusts) – Dow Jones U.S. REIT Index; hedge funds – Dow Jones Credit Suisse Hedge Fund Index; Private equity – Cambridge Associates U.S. Private Equity Index; infrastructure – Macquarie Global Infrastructure Index.

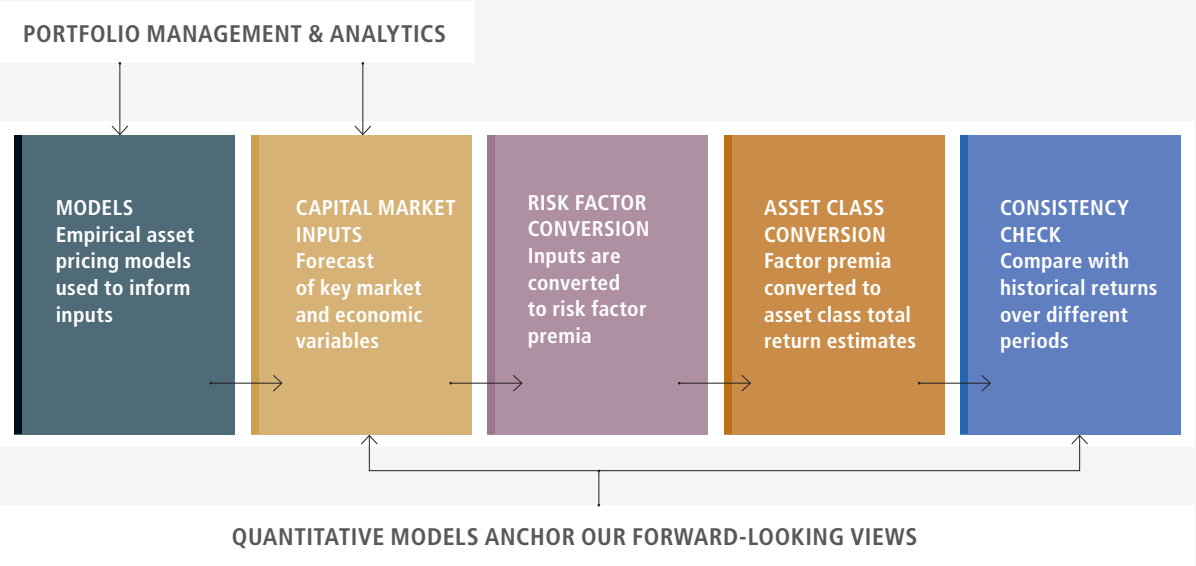
Capital Market Return Assumptions for Strategic Asset Allocation

Our long-term estimated returns are based on a structured internal survey, which queries senior portfolio managers (both generalists and specialists) for their forecasts for key markets. The survey is overseen by the asset allocation and the analytics teams.

The key inputs that are obtained through the survey process are forecasts for these data:

- Real GDP growth and inflation globally
- Equity valuations, dividend yields and earnings growth
- Nominal and real yield curves globally
- Foreign exchange rates against the U.S. dollar
- Investment grade and high yield credit spread levels, expected defaults and downgrades
- Sovereign credit spreads

A set of robust, well-established valuation models that map current market variables to expected returns serves as an anchor for the inputs in the survey process. For equities, country-specific cyclically adjusted earnings yields and estimates of equity risk premia over the local real interest rate relative to historical levels provide the most important analytical valuation anchor. Expected earnings growth is based on per capita real GDP growth estimates. For interest rates, the current yield level, the spread between current yields and forward rates alongside model-based estimates of long-term fair value for nominal and real yields are the most important analytical inputs which guide the expected long-term yields and model-based returns. For credit, the level of the current credit spread relative to history (adjusted for leverage ratios and composition across sectors and ratings quality) and historical defaults and downgrade losses are combined into a model-based forecast of future spreads and returns for both investment grade and high yield. For FX/currencies, real interest differentials are combined with a mean reversion toward purchasing power parity (PPP)-based fair value across countries to determine a model-based FX spot appreciation/depreciation and overall FX return.



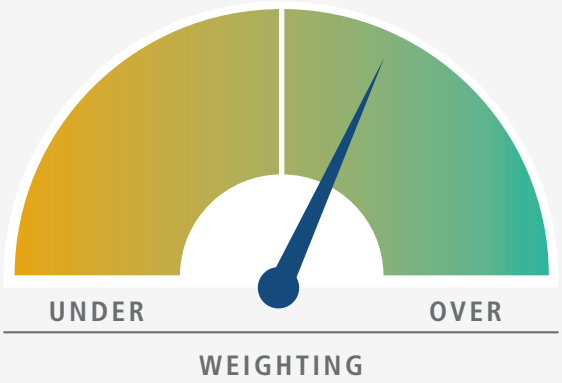
BUILDING ASSET ALLOCATION PORTFOLIOS

In our asset allocation portfolios, our investment decisions are made using a four-pronged framework:

- **We begin by gauging where in the globe macroeconomic conditions or policy actions are likely to produce the biggest surprises. These factors interact with macroeconomic fundamentals in ways that can have meaningful effects on asset returns.**
- **Then we conduct a rigorous analysis of cross-asset valuations and risk premia to inform our decisions on what to own long-term. This helps us determine our strategic allocations to various regions and asset classes.**
- **Next, we meet and debate often to assess short-term factors such as momentum, liquidity and investor flows, which help to indicate when trading may be warranted or even optimal.**
- **Finally, correlation and risk management considerations are incorporated to scale exposures.**

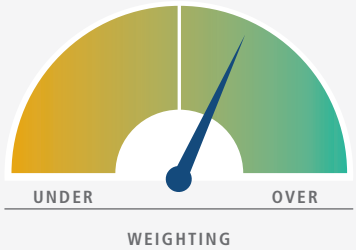
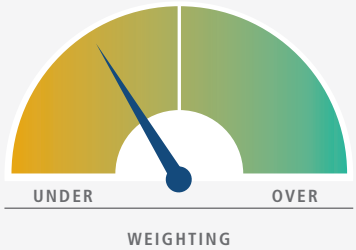
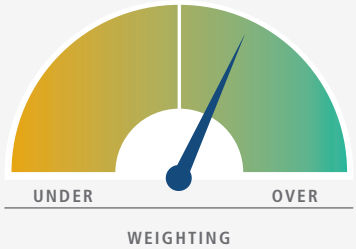
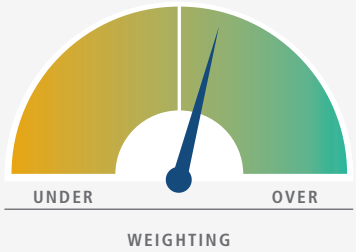
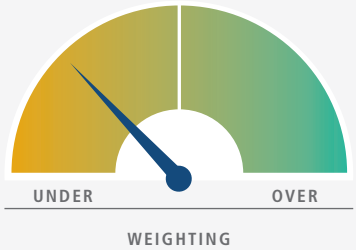
Asset Allocation Themes for Multi-Asset Portfolios

With the tailwind from ever-lower policy rates and term premia compression behind us, rather than see cause for alarm, investors should consider this a time to (1) refocus portfolio construction, (2) revisit sources of value through active management and (3) be judicious in asset allocation decisions. We believe investors will be best served if they consider opportunities across asset classes and throughout the globe.



OVERALL RISK

Despite the waning tailwind of declining discount rates on asset class returns, we believe investors should not only stay invested, but look for opportunities to strategically overweight risk positions over the long term. Moderate global growth and a gradual upward path to interest rate levels lower than in previous cycles should be supportive of asset classes, though support is more tilted to providing a floor than providing a boost.

POSITIONING	SECULAR OPPORTUNITIES
EQUITIES 	• A global survey of equity risk premia suggests fair to attractive valuations relative to bonds and recent history • Exposure in Europe and Japan appear attractive given policy efforts that are stimulating growth, the levels of dividend yields and current valuations • Emerging markets, particularly those in Asia, offer attractive opportunities for strategic overweights given macro trends, supportive policy and reforms, and levels of equity risk premia particularly when compared to recent history
RATES 	• Core fixed income retains its important role in a multi-asset portfolio to provide diversification and income • We are wary of exposure to interest rates in developed markets as rates are low and poised to rise • There are interesting opportunities in select EM countries, including Mexico and Brazil
CREDIT 	• Despite low all-in yields across credit sectors, spreads above government rates remain within fair to attractive levels • We find specific opportunities such as European financials and U.S. housing-related credits most attractive • A deeper appreciation for potential liquidity is needed given less inventory capacity at banks due to global banking regulations
REAL ASSETS 	• Global inflationary trends may be poised to reverse and gain positive momentum, bolstering the case for real assets • Inflation-linked bonds are particularly attractive as their prices continue to imply very low inflation premia when compared with nominal bonds • Differentiation and tactical agility will be necessary to extract attractive returns from commodities as we believe supply and demand are generally matched
CURRENCIES 	• We remain bullish on the U.S. dollar, and thus underweight international and emerging market currencies, given the divergence of Fed policy with most global central banks • There are select opportunities in higher-yielding EM currencies like the Indian rupee; investors should nevertheless be wary of the potential for heightened volatility

Global Equities

Positive long-term outlook

We are generally constructive on the potential for equities to deliver long-term returns, though (as noted above) our 10-year forecast for developed market equities is in the modest 4%–5% range, and slightly higher for emerging markets (which include additional idiosyncrasies and risks).

The factors favoring equities include muted inflation, an extended business cycle and low discount rates which, if they move up, will likely do so slowly and to levels still low by historical standards.

Looking around the globe, European equities appear attractive over the secular horizon. In addition to the broader developments discussed, the trend toward increased dividend payout and a higher equity risk premium provide a good backdrop for superior returns. European equities offer high levels of earnings yields and valuations are lower relative to history. We think a resolution of the Greece crisis would remove a source of uncertainty and allow the market to outperform.

European financials may be a good secular choice in equity space, as well as hybrid securities or subordinated debt. We believe European banks are now far advanced in raising capital and in reaching some degree of normalization in yields, and the shape of the yield curve should lead to higher profitability, which is already buoyed by the cheap funding the European Central Bank (ECB) continues to provide through sustained quantitative easing.

In Asia, Japanese equities also offer strong secular return prospects. They have some of the best earnings growth momentum in the developed markets and stand to further benefit from the quantitative easing and structural reforms that are improving corporate governance and profitability.

We also favor equities in China and India: Both countries have embarked on secularly far-reaching reform agendas that should diminish vulnerabilities and unleash value. In particular, we should point out that the "bubble" and extreme valuations are confined to a small part of the Chinese market and recent volatility affords attractive entry for long-term investors into the more reasonably valued HSCEI (H shares).

China: A tale of different markets – picking the right one is important

Index	Market capitalization ($ billions)	Price-to-earnings ratio, 12-month trailing	Price-to-book ratio	YTD return (local currency, %)	12-month return (local currency, %)	Dividend yield (%)
Shanghai Stock Exchange Composite Index	5,229	20.3x	2.4x	24.3	98.1	1.6
Shenzhen Stock Exchange Composite Index	3,303	52.3x	4.6x	50.4	92.4	0.5
ChiNext Price Index	336	86.1x	10.1x	82.7	97.9	0.3
Hong Kong Stock Exchange Hang Seng China Enterprises Index (HSCEI)	388	8.7x	1.2x	2.7	18.9	3.4

Source: Bloomberg as of 13 July 2015

Equity market scorecard: key valuation indicators

Country/region	Index	Cyclically adjusted P/E	Cyclically adjusted earnings yield	Real yield on 10-year government bond	Equity risk premium estimate
U.S.	S&P 500	23.2	4.3%	0.5%	3.9%
Eurozone	EURO STOXX 50	15.2	6.6%	-0.1%	6.7%
Germany	DAX	18.7	5.4%	-0.5%	5.9%
France	CAC 40	16.6	6.0%	-0.4%	6.4%
U.K.	FTSE 100	16.7	6.0%	0.0%	6.0%
Canada	TSX 60	19.3	5.2%	0.0%	5.2%
Australia	ASX 200	18.8	5.3%	0.7%	4.6%
Japan	TOPIX	25.3	4.0%	-0.6%	4.5%

All fundamental data are taken from Bloomberg. All figures are on a consolidated basis. Trailing returns are local currency total returns. Data as of 3 July 2015.
Cyclically adjusted price-to-earnings ratio is calculated as the ratio of the average of the inflation-adjusted price to the median of 10-year trailing real earnings. This is a variant of Shiller's P/E ratio. Cyclically adjusted earnings yield is the inverse of the cyclically adjusted price-to-earnings ratio. Real yields reflect the market real yield for each country or economy's 10-year maturity inflation-linked bond. For the FTSE 100, the real yield has been adjusted upward by 80 basis points to account for the basis between the UK's Retail Prices Index (RPI) and Consumer Price Index (CPI) inflation indexes. The real yield for the EURO STOXX 50 index reflects a weighted average of the 10-year real yields of the component countries.

Global Fixed Income

Differentiation Is Critical in Anchor Asset Class

Fixed income should remain a cornerstone of multi-asset portfolios for the foreseeable future as The New Neutral remains an anchor for fixed income valuations. However, ahead of the first Fed hike in almost 10 years, we are cautious on developed market duration in our portfolios and encourage investors to consider the full spectrum of global opportunities in fixed income.

In the developed markets we are likely to see term premium return to yield curves. There are two potential scenarios that could lead to higher long-term rates. The first would be the decline of fears of deflation and the end of the strong bid for high quality bonds that markets experienced when developed economies recently teetered on the edge of recession. A second scenario, more likely to manifest toward the latter part of our secular horizon, may be the unwinding of the global savings glut. Brought on by cheaper oil and commodity prices resulting in less petrodollars and/or a Chinese economy balancing away from export-oriented to consumption-oriented growth, both possibilities lead to fewer dollars recycling into U.S. Treasuries and other safe-haven government bonds.

Further, we could see the re-injection of "credit risk" into the government bonds of Italy and other peripheral European countries. Current yields and spreads compared to German government bonds may be attractive given the backdrop of ECB support. However, when asked to stand on their own, these bonds should not be trading at yields close to U.S. Treasury yields unless debt burdens are reduced and the economy is made more competitive.

We are secularly positive on Mexican interest rates as inflation has been reined in and Mexico has built significant fiscal and monetary policy credibility over the past several years. While Mexico's central bank is expected to raise rates in tandem with the Fed, we believe the market has priced in too many hikes. Credibility and institutional stability should see the spread of Mexican Bonos (Mexican government bonds with a fixed interest rate) to U.S. Treasuries compress in our secular horizon; we favor the intermediate part of the curve.

We are also hopeful that Brazil will move past its recent challenges to see better prospects ahead with a better mix of monetary and fiscal policies and more investor-friendly policies. The extremely high real interest rates would be very attractive if inflation were tamed and political and economic volatility reduced.

Credit spreads

As mentioned earlier, we believe credit spreads are broadly fair and provide adequate compensation for default risk. In such a scenario, and with no expectations of an elevated default cycle any time soon, one should earn the credit risk premium by investing in privately issued debt. However, credit differentiation and the identification of broad themes become more important in a world of diminished liquidity for specific industries and sectors that we find attractive on a secular basis (see the *Secular Series* publication, "Picking U.S. Energy, Housing and Other Credit Sectors for the Long Haul"). Some of these include the consumer and housing-related sectors in the U.S. and financials, including bank capital, in Europe and Japan.

In a world of diminished liquidity and mostly fair valuation for corporate bonds, it is perhaps appropriate to talk about a broad sector that still offers attractive return potential at the cost of sacrificing liquidity: private opportunities that require capital to be locked up for a period of time. There is a role for investors to take advantage of these as sources of financing from banks and other traditional lenders fade. These deals are often complex, and illiquid as advertised, but can be rewarding to institutions and investors who have the expertise to decipher the intricacies and unlock value. At PIMCO, we believe that this sector offers a win-win as investors seek higher returns than those offered by publicly traded stocks and bonds, and borrowers need capital that banks can no longer provide. (Please see our forward-looking return estimates for illiquid asset classes on page 6.) Our expectations are for the average private-equity-type investment to return approximately 2% more than equities, with lots of room for differentiation and opportunistic investment leading to potential outperformance.

Real Assets

Key Opportunities as Inflation Gradually Rises

As we see inflation accelerating, albeit gradually, over the secular horizon, we suggest investors consider an allocation to real assets, meaning assets that directly or indirectly hedge inflation risk (see the *Secular Series* piece, "Inflation Outlook: Approaching Target").

For the core government bond anchor in a multi-asset portfolio, we like U.S. TIPS (Treasury Inflation-Protected Securities). Not only are they an asset carrying only one risk, real rate risk (unlike nominal government bonds that carry both real rate and inflation risks), but we also view them as attractively valued relative to nominal bonds. The large amount of slack in the global economy over the past few years as well as the recent commodity price correction have resulted not only in a drop in inflation expectations (and fears of possible deflation until recently), but also in a near complete removal of inflation risk premium from the markets. Under these conditions, we think TIPS are an attractive choice for the core fixed income component of a multi-asset portfolio.

Commodities are another asset class that embodies the greater differentiation within asset classes that we expect going forward. During the supercycle of the early 2000s, when demand growth outpaced supply growth, most commodity sectors rose together. Then, as supply caught up over the last few years, we saw declines across most commodities. Going forward, supply and demand should be better matched and investors will have to be more selective in order to generate returns.

For example, we think U.S. natural gas stands out as attractive, with long-dated natural gas prices around $3.00/MMBtu (millions of British thermal units) trading close to prices where it is economical to substitute gas for coal in U.S. power production and significantly below the prices where natural gas trades in the rest of the world. Supply is likely to drop with a slowdown in fracking. Meanwhile, demand is likely to increase as the world looks for cleaner energy sources and the political process in the U.S. possibly allows for greater energy exports.

We also believe gold is losing its shine. The two biggest drivers of gold prices, U.S. real interest rates and the U.S. dollar, should both move modestly higher over the secular horizon, affecting financial market demand. Physical demand from India could also cool as the financial markets mature and the government promotes viable alternatives to gold for savings and wealth preservation.

Finally, an important element of commodity prices is the announcement of the anticipated agreement with Iran. While geopolitical risk in the Middle East has been a source of supply disruptions leading to higher prices, peace with Iran should bring additional oil into the global market, leading to a cap on long-term prices.

Currencies

Continuing Strength in U.S. Dollar

Over the secular horizon, the major factors driving currency returns are interest rate differentials and inflation surprises. We continue to expect broad strength in the U.S. dollar over the early part of the secular horizon. We expect the Fed to be the first major central bank to hike rates as the U.S. economy is a few years ahead of other major economies in its recovery.

This divergence will lead to U.S. dollar strength versus most developed economies where current policy is likely to further weaken local currencies.

In the latter part of the secular horizon we could see strong returns from the higher-yielding EM currencies like the Brazilian real (BRL) or the Indian rupee (INR) if inflation rates are stable enough to attract outside capital. The offshore exchange market in the Chinese yuan (CNH) also bears watching for possible appreciation as China further loosens capital controls; the CNH is more widely accepted in global trade (including becoming part of the International Monetary Fund's Special Drawing Rights (SDR) basket).

Risks to our outlook

PIMCO's latest Secular Outlook details the key investment risks over the secular horizon. One primary secular risk that investors should keep in mind is that while we do not expect a major recession and continue to expect central banks to go "all in" to support growth, should a recession occur when major global central banks are all operating at or near the zero bound and with already bloated balance sheets, they may have little room to maneuver to engage countercyclical policies.

Another secular risk is a bout of higher inflation. We see a move away from deflation or "lowflation" territory and toward central bank targets. Inflation is a notorious lagging, late-cycle indicator. It is possible that central banks misjudge the degree of slack in the economy and easy and unconventional policies result in a period of higher-than-expected inflation. This would be negative for returns in both bonds and stocks, positive for commodities.

Geopolitical risks also cast a shadow on our outlook. There are several known potential flash points around the world, and many that cannot yet be anticipated. A key development to watch is the evolution of the relationship between China and the U.S. as the former asserts itself more on the global stage.

While risks to the base case are ever present, they are by definition uncertain in likelihood and timing. As such, robust portfolio construction, diversification and identifying investments with "positive convexity" become particularly important in a world of lower expected returns.

Finally, though one often thinks about "left tails" when talking about risks, there is also the possibility of "right tails" over the secular horizon. For example, strong upside catalysts might include the end of political gridlock or improved fiscal policy, both of which may lead to stronger growth rates than the muted ones we expect in the U.S. and Europe. This development would obviously be positive for risk assets like equities and credit.

Asset Allocation Best Ideas: A Secular Perspective

As our survey of the outlook for major asset classes demonstrates, investors likely should reconsider their long-term paradigm to multi-asset portfolio construction. This is not because we forecast a bear market in equities or other dramatic turns. It is because The New Neutral has mostly been priced in to asset valuations, and investors should be well-served by differentiating among broad allocations and being diligent in examining specific opportunities to seek those with compelling risk-return potential.

Broadly, our secular bias is to overweight equities and credit fixed income and underweight government bonds. Patient investors may also benefit from overweighting exposure to emerging markets, though they need to be careful about how they execute and stay aware of the risks. Finally, while not suitable for all investors, illiquid, private investments, if prudently chosen, can offer superior return potential and diversification in an era of shrinking government and bank budgets.

The next step is to be tactical, which includes the perennial admonition to "do your homework." Yet from a tactical standpoint, there is one aspect of our New Neutral thesis to consider both for risk and return: We are likely to see substantial bouts of volatility ahead. In the near term, we expect the Federal Reserve will conduct its first policy rate hike later this year. While we expect the Fed to move gradually over time to a lower "neutral" policy rate than in previous cycles, we believe investors may be underestimating the volatility that could ensue from moving off the zero bound. Longer term, we see greater likelihood of flash crashes and general volatility resulting from the global banking system, which as a result of post-crisis regulation allocates less of its balance sheet to making markets. The banks may be "safer," but markets are less liquid at times when liquidity is needed. Another area of focus should be on predicting forward-looking correlations. Portfolios that appear well-diversified based on historical data may turn out to be less so in practice.

Issues of liquidity and volatility should be of concern to investors, but they can also be sources of opportunity when securities pricing becomes divorced from fundamentals. There is reason for cautious optimism among investors revisiting their approach to multi-asset portfolio construction for the long term.

The Asset Allocation team leverages firmwide resources

Mihir P. Worah
CIO Asset Allocation and Real Return

- PIMCO Investment Committee member
- Generalist portfolio manager
- 14 years of investment experience

Role: Asset allocation and portfolio construction

Geraldine Sundstrom
Managing Director, Asset Allocation

- Global macro and absolute return investment experience
- 17 years of investment experience

Role: Asset allocation and portfolio construction

Rahul Devgon
Senior Vice President

- Macro and technical trading
- Global macro and absolute return investment experience
- 16 years of investment experience

Role: Global macro and relative value trading

Asset Allocation Portfolios

Mohsen Fahmi
Managing Director

- PIMCO Investment Committee member
- Global macro and absolute return investment experience
- 30 years of investment experience

Role: Global macro and relative value trading

Nic Johnson
Executive Vice President

- Real assets and relative value investment experience
- 11 years of investment experience

Role: Real assets and relative value

Lorenzo Pagani, Ph.D.
Managing Director

- Head of European government bond and rates desks
- European portfolio committee member
- Counterparty risk committee member
- 12 years of investment experience

Role: Fixed income relative value

FULL PIMCO RESOURCES

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60+ Research Analysts
60+ Portfolio Analytics Analysts

PORTFOLIO ANALYTICS

Ravi Mattu
Managing Director

- Global head of analytics
- 33 years of investment experience
- 60+ portfolio analytics analysts

RISK MANAGEMENT

Bill De Leon
Managing Director

- Global head of portfolio risk management
- 24 years of investment experience
- 10 portfolio managers and 25+ legal advisors

The **"risk-free" rate** can be considered the return on an investment that, in theory, carries no risk. Therefore, it is implied that any additional risk should be rewarded with additional return. **All investments** contain risk and may lose value.

Past performance is not a guarantee or a reliable indicator of future results. 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. Charts are provided for illustrative purposes and are not indicative of the past or future performance of any PIMCO product.

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. **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. **Currency rates** may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. **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. **Inflation-linked bonds (ILBs)** issued by a government are fixed income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. **Treasury Inflation-Protected Securities (TIPS)** are ILBs issued by the U.S. government. **Commodities** contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors.

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 long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

Return estimates are for illustrative purposes only and are not a prediction or a projection of return. Actual returns may be higher or lower than those shown and may vary substantially over shorter time periods.

The **Australian Stock Exchange ("ASX")** was formed in 1987 through the amalgamation of six independent stock exchanges. ASX operates Australia's primary national stock exchange for equities, derivatives and fixed interest securities and facilitates capital raisings for unlisted companies. The resources sector – mining and energy businesses – accounts for one-third the market capitalization; industrials – including banks, retail, media, and transportation - comprise the balance.

Barclays Global Aggregate (USD Hedged) Index provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian Government securities, and USD investment grade 144A securities.

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. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Barclays 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.

Barclays U.S. TIPS Index is an unmanaged market index comprised of all U.S. Treasury Inflation Protected Securities rated investment grade (Baa3 or better), have at least one year to final maturity, and at least $250 million par amount outstanding. Performance data for this index prior to 10/97 represents returns of the Barclays Inflation Notes Index.

The **Bloomberg Commodity Total Return Index** is an unmanaged index composed of futures contracts on 22 physical commodities. The index is designed to be a highly liquid and diversified benchmark for commodities as an asset class. Prior to 30 June 2014, this index was known as the Dow Jones UBS Commodity Total Return Index.

The **CAC 40** is a French stock market index, a benchmark index for the Paris Bourse (stock exchange). The index represents a capitalization-weighted measure of the 40 most significant values among the 100 highest market caps on the Paris Bourse. Its base value of 1,000 was set on December 31, 1987. As of December 1, 2003, the index has become a free float weighted index.

The **Cambridge Associates U.S. Private Equity Index** is based on returns data representing nearly two-thirds of leveraged buyout, subordinated debt, and special-situations partnerships since 1986.

ChiNext is an independent market, offering a platform for the needs of enterprises engaged in independent innovation and other growing venture enterprises. The ChiNext board indices comprehensively and objectively reflect the overall price move of ChiNext board stocks. It is launched and released on 06/01/2010.

The **Citigroup 3-Month Treasury Bill Index** is an unmanaged index representing monthly return equivalents of yield averages of the last 3 month Treasury Bill issues.

The **DAX 100 Index** is a total rate of return index of the 100 most highly capitalized stocks traded on the Frankfurt Stock Exchange.

The **Dow Jones Credit Suisse Hedge Fund Index** is an unmanaged index compiled by Credit Suisse Hedge Index LLC and CME Group Index Services LLC. It is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The index uses the Credit Suisse Hedge Fund Database, which tracks approximately 8,000 funds and consists only of funds with a minimum of US$50 million under management, a 12-month track record, and audited financial statements. The index is formerly known as the Credit Suisse/ Tremont Hedge Fund Index.

The **Dow Jones U.S. Select Real Estate Investment Trust (REIT) Index** is an unmanaged index subset of the Dow Jones Americas U.S. Select Real Estate Securities (RESI) Index. This index is a market capitalization weighted index of publicly traded Real Estate Investment Trusts (REITs) and only includes only REITs and REIT-like securities.

The **EURO STOXX 50 Index**, Europe's leading blue-chip index for the Eurozone, provides a blue-chip representation of supersector leaders in the Eurozone. The index covers 50 stocks from 12 Eurozone countries.

The **FTSE 100 Index** is a capitalization-weighted index of the 100 most highly capitalized companies traded on the London Stock Exchange. The equities use an investibility weighting in the index calculation. The index was developed with a base level of 1000 as of January 3, 1984.

The **Hang Seng China Enterprises Index** is a free-float capitalization-weighted index comprised of H-Shares listed on the Hong Kong Stock Exchange and included in the Hang Seng Mainland Composite Index. The base value of this index is 2000 as of Jan 3, 2000.

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 Emerging Local Markets Index Plus (Unhedged) tracks total returns for local currency-denominated money market instruments in 24 emerging markets countries with at least U.S. $10 billion of external trade.

The **JPMorgan Government Bond Index-Emerging Markets** (GBI-EM) indices are comprehensive emerging markets debt benchmarks that track local currency bonds issued by Emerging Market governments. The index was launched in June 2005 and is the first comprehensive global local Emerging Markets index.

The **Macquarie Global Infrastructure Index** Series (MGII), which is calculated and managed by FTSE, is designed to reflect the performance of companies within the infrastructure industry, principally those engaged in the management, ownership and or operation of infrastructure and utility assets.

The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The **MSCI Europe Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe. The MSCI Europe Index consists of the following 16 developed market country indices: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

The **MSCI Japan Index** is a market capitalization weighted index composed of approximately 277 issues, and is generally representative of the market structure of Japan.The index is calculated separately; without dividends, with gross dividends reinvested and estimated tax withheld, and with gross dividends reinvested, in both U.S. Dollars and local currency.

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 **S&P/TSX 60 Index** is a list of the 60 largest companies on the Toronto Stock Exchange as measured by market capitalization. This Canadian index offers exposure across 10 economic sectors, and is maintained by the Canadian S&P Index Committee.

The **Shanghai Stock Exchange Composite Index** is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. The index was developed on December 19, 1990 with a base value of 100.

Shenzhen Composite Index is an actual market-cap weighted index (no free float factor) that tracks the stock performance of all the A-share and B-share lists on Shenzhen Stock Exchange. The index was developed on April 3, 1991 with a base price of 100.

The **TOPIX (Tokyo Stock Price Index)** is a capitalization-weighted composite of all stocks trading on the first section of the Tokyo Stock Exchange ("TSE"), supplemented by size groups that classify first section companies as small, medium, and large and by sub-indices for each of the 33 industry groups. It is not possible to invest directly in an unmanaged index.

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