

Secular Outlook

June 2009

Andrew Balls Discusses PIMCO's European Secular Outlook



Andrew Balls

Mr. Balls is a managing director in the London office, a member of the Investment Committee and head of European portfolio management. (He leads PIMCO's European investment team, which is based in London and Munich, and manages European and global portfolios.) Mr. Balls was previously a global portfolio manager in Newport Beach and the firm's global strategist. He has 11 years of investment and financial market experience and holds a bachelor's degree from Oxford and a master's degree from Harvard University. He was a lecturer in economics at Keble College, Oxford.

In the following interview, Andrew Balls highlights the conclusions from PIMCO's recent Secular Forum and explains how they influence the firm's European investment strategy. The Secular Forum is an annual event that brings together investment professionals from around the world to formulate the firm's three- to five-year economic and market outlook. Outside experts help frame the discussions and add insight on key factors that are part of the debate. The secular outlook guides the firm's investment strategy, product development, client servicing and business management.

Q: This year's Secular Forum took place during a period when the markets showed signs of stabilization and even green shoots of more positive data. Do the key conclusions from the Secular Forum also reflect this optimism for the long term?

Balls: We have some optimism that over the course of the secular horizon we will move to a more balanced global economy with more sustainable sources of demand growth than experienced during the past few years. But this is going to be a difficult adjustment and a bumpy secular journey. The improvement in the market mood and some indications of stabilisation in the macro data since March is not a surprise given the collapse in the data and the very sharp selloff in equities that preceded it. But this is not going to be a typical, mean-reverting cyclical recovery owing to the extent of the damage that has been done to global markets and the global economy.

Q: PIMCO often characterizes the current financial situation as a crisis of the system, as opposed to a crisis *within* the system. Could you explain the implications of this diagnosis?

Balls: This is a crisis in the very heart of the global system: It began in the U.S. housing market and the U.S. non-bank financial sector but has spread throughout the global financial system and to the banks at the heart of the system. The emerging market crises of the late 1990s were dramatic and certainly touched the OECD (Organisation for Economic Co-operation and Development) countries, but this time the crisis emanated from the very core. The system has not been able to right itself – there have been no internal circuit breakers – meaning that the crisis has morphed from the financial sector to the real economy. The uncontrolled failure of Lehman Brothers was a

Secular Outlook

June 2009

shock that affected financial markets and the real economy globally, making a bad situation much worse. The U.S. and the U.K. were the countries most exposed to the abrupt turn in the leverage cycle, but we have seen a clear demonstration of how leveraged other countries including Germany and Japan were to the inflated global growth. The scale of the problem has brought unprecedented government interventions globally. The impact of these interventions will be felt over the secular horizon as emergency measures lead to permanent changes. The secular implication is that the global system is going to have to change and that we will not return to the old normal.

Q: What factors are likely to characterize the “new normal” economic and financial reality? How will this new normal in the U.K. and the euro zone differ from the U.S.?

Balls: Our assessment is that the secular outlook involves weaker global growth and especially weaker growth in the developed countries. Governments and central banks have become deeply involved in financial markets across the world and exiting from these interventions will be a difficult process. Without intervention, the depth of the banking sector’s problems would have led to a more severe market-enforced deleveraging and de-risking. The extent of the required government stabilisation and injection of taxpayer money will require significantly tighter regulation.

Across the world we see difficult secular challenges: tradeoffs between government policy support and governments’ failure to offer support, a shifting and realignment of global savings and investment balances, and an adjustment to lower global growth than we’ve been used to in recent years. These factors apply across countries, including the U.K. and Europe. Bill Gross has characterized the adjustment we are going to see as a combination of reregulation in the financial sector; deleveraging, with secular as well as cyclical implications; and deglobalization, with more friction in the flow of global investments and savings across borders.

In the euro zone, the drop in external demand is leading to very sharp adjustments in trade balances and questions over the extent to which external growth will continue to be a locomotive for countries such as Germany. Moreover, within the euro zone, Germany benefited from demand from the previously strong growth in countries such as Spain and Ireland that has been thrown into reverse. In the U.K., we see similar dynamics in terms of deleveraging and its broad impact that we see in the U.S. and similar over-reliance on the financial sector in recent years. We also see the huge increase in government borrowing. But because the U.K. is a small and open economy without the benefit of reserve currency status, the tail risks in the U.K. secular outlook are greater, we think, than in the euro zone or the U.S.

Q: The Bank of England (BOE) and to a lesser extent the European Central Bank (ECB) have enacted unconventional policy responses. Do you expect them to relent somewhat from their accommodative policy stance over a secular timeframe?

Balls: In the short term, governments have had to do very extensive interventions. The scale of those interventions reflects the weak initial conditions, with the U.K.’s exposure

Secular Outlook

June 2009

to deleveraging greater than the euro zone's. The U.K. has had well-designed interventions, leading the way in financial sector interventions in addition to the BOE's credit easing and quantitative easing, in part because the authorities did not have the luxury of waiting and seeing.

The ECB has been more cautious about credit easing and is very reluctant to engage in buying government bonds, but has been aggressive in providing liquidity to the markets. There are clear divisions within the ECB on how far they should go in terms of intervention and over time this will be determined by the depth of the slowdown and the extent of the deflation threat. But the ECB is likely to remain more cautious, as it is the central bank for a group of countries and does not have a direct fiscal counterpart. And it is likely to remain more concerned about eventual inflation risks and seems ready to tolerate a period of very weak growth and deflation in the meantime.

In the U.K., policymakers will have to continue their extensive interventions in the early part of the secular horizon. The difficult question on quantitative easing is: Once you are in, how do you get out? Markets adapt to these prolonged interventions and a smooth exit will not be easy to achieve, probably meaning that the BOE will err on the side of waiting too long rather than trying to withdraw the stimulus too early. In Europe, the extent to which the ECB and governments enact further unconventional policy responses will be determined by both the course of the economy and by weaker member states in Europe's Economic and Monetary Union that need support. Even since the Secular Forum we've seen the ECB step farther into credit easing with its program to buy European Covered Bonds.

Part of the secular outlook involves anticipating and navigating the intended and unintended consequences of these government actions as they unfold, and evolving the outlook over time as countries seek exit strategies from these unconventional and unprecedented interventions.

Q: With all this monetary and fiscal stimulus, what is the economic outlook for the U.K. and the euro zone?

Balls: The near-term outlook looks bad for the U.K., the euro zone and virtually the whole of the rest of the world. The "green shoots" point to a slower pace of decline rather than a robust near-term recovery. Following September's cardiac arrest in the global economy, nearly everyone was knocked to the ground. One big secular question concerns the sequencing of recoveries and the nature of the growth. Globally, do countries pull themselves up and help pull others with them? Or is there a danger that countries get up themselves via government interventions, including industrial policy, at the risk of pushing others down?

Growth has been stimulated by direct and indirect exposure to the global leverage cycle, and deleveraging will have medium-term effects. Government intervention and re-regulation is also likely to have an impact on productivity growth and the need to fund huge government interventions may crowd out private investment. If in the old normal potential growth was around 2¾% in the U.K. and close to 2% in the euro zone,

Secular Outlook

June 2009

in the new normal potential growth may be 2% in the U.K. and lower than that for the euro zone.

Q: What is PIMCO's forecast for inflation in the U.K. and in the euro zone over a longer-term horizon?

Balls: In the near term we see strong cyclical disinflationary pressures, with inflation already very low in the euro zone and moving downward in the U.K., and risks of significant undershoots to the BOE's inflation target. Farther out in the secular horizon, there are reasons to think that there are upside tail risks of inflation, particularly in the U.K. if the authorities and their interventions overstay their welcome. The cost of hedging against a very deep downturn now could be higher inflation farther out.

In the euro zone, the risks of inflation are more balanced, given the greater willingness to tolerate the deep downturn in growth and less extensive policy reactions. However, farther out in the secular outlook, the euro zone may still see some upside inflation pressures resulting from the less benign global inflation backdrop.

Q: How is the increasing involvement of the governments affecting the economy and the investment environment in the U.K. and the euro zone?

Balls: As mentioned, we feel that increasing government intervention in markets and increasing regulation will contribute to somewhat lower productivity growth over time. Looking ahead, with increased government involvement in markets, and less flexible markets, there is likely to be a risk of higher inflation. And the eventual exit from extensive interventions and the challenges surrounding the exit from these policy mechanisms are additional complicating factors for investors navigating the secular economic environment. It is not enough to focus only on fundamentals as market drivers – we are now in a secular period in which governments are players as well as referees in financial markets, and we have to take this into account across our range of investment strategies.

Q: What is PIMCO's view on the euro area's recent tensions within the monetary union?

Balls: We've had a very significant shock to a monetary union made up of sovereign nations, with very different initial conditions and with imperfect shock absorbers in terms of flexibility of the economies and in terms of physical transfers. The impact will be felt differently across member states of the monetary union, making it harder to design and implement policy responses. So far, this has probably resulted in a less aggressive policy response. One secular question is the extent to which problems in the weaker euro countries will require support from the core, including fiscal transfers and more aggressive ECB actions. An additional source of risk is to what extent problems in Eastern Europe feed back to the euro zone, mainly through the exposure of euro zone banks.

Secular Outlook

June 2009

Q: How is PIMCO positioning its global portfolios to deal with this bumpy journey to a new destination?

Balls: Our baseline is for weak growth in OECD countries and there are a range of risks to the baseline, notably related to government interventions. Global markets are also going to have to absorb a very large amount of government debt issuance. Our baseline favors the front end of yield curves, reflecting the fact that rate hikes will be some time in coming owing to the macro outlook and the fact that governments have greater control of the front ends of curves.

We see the euro zone as a more attractive place to take duration, given our expectation of weaker growth and the ECB's persistent focus on inflation that leads to less aggressive policy responses than we see elsewhere in the world. In the U.K., similar to the U.S., we see the front end of the curve as the best place to take risk, as we expect the BOE will be on hold at very low interest rates for longer than is priced in by the forward markets. We are more cautious on duration owing to the greater tail risks in the U.K. as a small open economy without the benefits of the U.S.'s reserve currency status, and the risks associated with quantitative easing and the eventual exit from quantitative easing.

Overall, we plan to maintain a high quality bias in the portfolios, again reflecting the difficult nature of this secular adjustment. This overall strategy translates into a focus on assets that generate steady and predictable income, rather than assets bought in anticipation of sizeable capital gains. We want to remain high up in the capital structure (of the economy as well as of issuers) with only select exposures lower down the capital structure. In credit, this translates into a focus on national champions and core industries.

Thank you, Andrew.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. 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. Government securities are backed by the full faith of the issuing government; portfolios that invest in them are not guaranteed and will fluctuate in value. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

Forecasts, estimates, and certain information contained herein are based upon proprietary research. There is no guarantee that results will be achieved. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should

Secular Outlook

June 2009

evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.

Duration is the measure of a bond's price sensitivity to interest rates and is expressed in years.

This material contains the current opinions of the author but not necessarily those of PIMCO and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. Pacific Investment Management Company LLC, 840 Newport Center Drive, Newport Beach, CA 92660, 800-387-4626. ©2009, PIMCO.