

Viewpoints

September 2009

Beyond Inventories and Fiscal Stimulus



Tony Crescenzi

Senior Vice President, Portfolio Manager

Tony Crescenzi is a senior vice president, market strategist and portfolio manager in the Newport Beach office. Prior to joining PIMCO in 2009, he was chief bond market strategist at Miller Tabak, where he worked for 23 years. He helped create that firm's asset management division and served as its chairman. Mr. Crescenzi has written three books, including his latest, *Investing from the Top Down*, which was published in 2008, and a 1,200-page revision to Marcia Stigum's classic, *The Money Market*. He taught in the executive MBA program at Baruch College from 1999–2009. He has 26 years of investment experience and holds an MBA from St. John's University and an undergraduate degree from the City University of New York.

Trends in the financial markets in recent months have been rooted partly in the idea that the U.S. and the world are experiencing a cyclical upturn in economic activity. Investor sentiment is being influenced in particular by data from the factory sector, which has improved mainly because in many industries production had fallen below sales. In other words, producers had cut production too much relative to demand and are now recalibrating their production levels to demand. This is boosting key data such as the Institute for Supply Management's monthly purchasing managers index and reducing the impetus to cut jobs. Ultimately, however, secular forces will restrain economic activity and limit the scope for extending recent trends in the financial markets.

Risk assets, including equities and corporate bonds, for example, have benefitted from the improved tone of economic data at the expense of U.S. Treasuries. This is likely to continue until there is a break in the ever-improving tone of the data, although there are some signs that investors are already looking past the inventory cycle. It will take time before investors fully look past the inventory-led rebound, as there is momentum in the economy and data will look upbeat. For example, the new orders component of the ISM, which accounts for 30% of the index and is of course a leading indicator, reached 64.9 in August, its highest since December 2004. Numerous data are likely to improve in the time ahead as a result of the recalibration of production to demand, reinforcing recent market trends. Despite the pickup in growth, Treasury yields have fallen from their highs, possibly because investors are starting to look past the inventory story, as well as the impact of fiscal stimulus. For yields to rise, the embrace of the growth theme must take hold for longer.

For market trends in risk assets (including the stock market rally) to extend meaningfully, investors will require evidence that the inventory-led rebound in economic activity is evolving. There is no evidence of this just yet; the recovery is very fragile, like a small campfire that just can't get going because of the many winds surrounding it.

Three Major Constraints to Growth

While there is no doubt that the direction of change for the U.S. economy is up, the magnitude of change is likely to be restrained by a number of factors, limiting ultimately the market response and the scope for risk assets to rally and for Treasury yields to rise. Three factors stand out:

1. Income growth
2. Wealth destruction
3. Credit availability

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A fourth factor beginning late next year and in 2011 will be a sizable fiscal drag, which will likely become a policy issue next year. Regulations on financial as well as on other industries – for example, higher capital requirements – pose additional challenges to growth.

Here are some notes on the above three points:

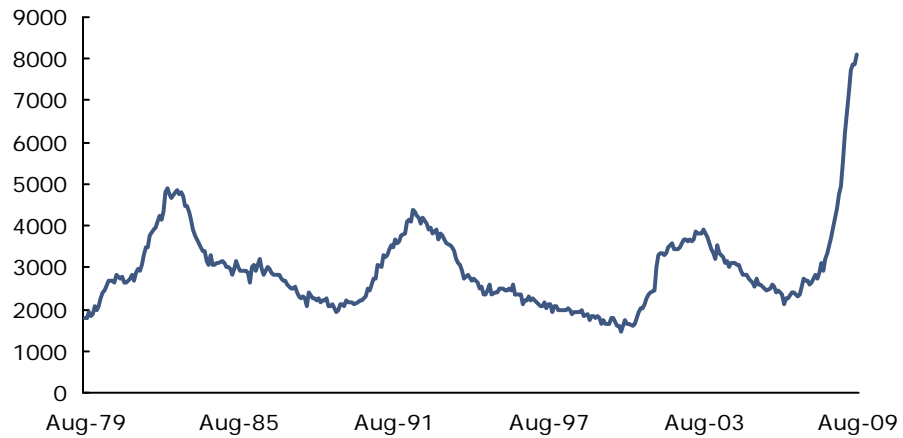
1. Many of the jobs lost during the recession are “permanent,” resulting from restructuring in many industries such as the finance and automobile industries (see Chart 1). This will restrain income growth both because job growth will likely be weak in any recovery and because the large pool of available workers will put downward pressure on wages. It took three years to recover all of the jobs lost during the past two recessions; it will probably take four to five years to recover the jobs lost during the current recession.
2. The recent rally in financial markets has restored some of the wealth households recently lost, but the magnitude of the loss has been much larger (see Chart 2). This should keep the savings rate on an upward path and restrain consumer spending. Remember the rule: for each dollar that wealth changes, spending changes by about four cents, studies show. The savings rate has thus far increased about what would be expected given the nearly \$15 trillion decline in wealth, meaning that there has yet to be a meaningful increase associated with the deleveraging impetus.
3. Credit is of course still difficult to obtain for both the household and business sector. This is evident in recent bank loan data, which as of August have shown no signs of improvement (see Chart 3 on commercial and industrial loans and Chart 4 on bank cash).

It is of course possible that endogenous factors related to the recent loosening of financial conditions combined with a revival of the “animal spirits” in the private sector could kindle more growth than seems likely. Moreover, innovation and efficiencies tend to evolve in periods of weak economic activity that could help propel growth in the time ahead. Continued growth in productivity also augurs well – it is a vital ingredient to improvements in the nation’s standard of living. Still, it will be difficult to overcome the numbers – in particular the mountain of public and private debt, and the sparse growth rate in incomes.

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“Permanent” job losses have been unusually high:

Civilians Unemployed: Other Job Losers
As of August 2009, Seasonally Adjusted, Thousands

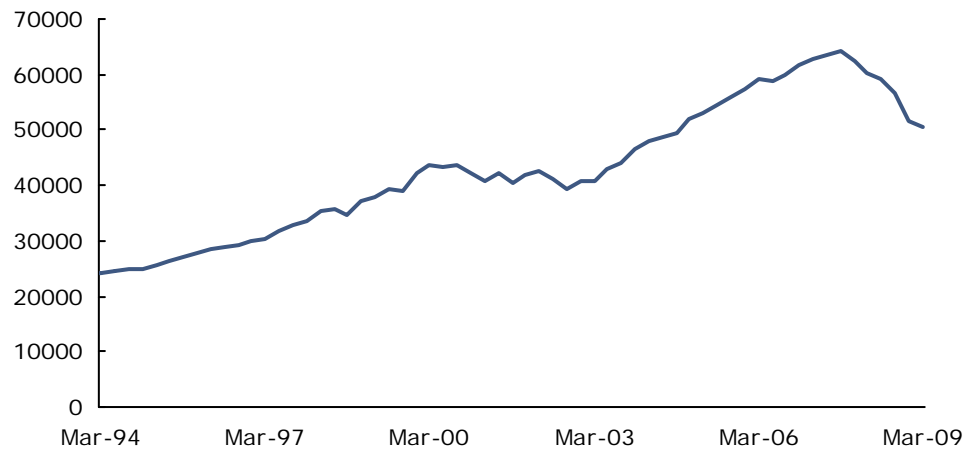


Sources: Bureau of Labor Statistics, Haver Analytics

Chart 1

Household net worth has plunged and is leading to a rise in the U.S. savings rate:

Households and Nonprofit Organizations: Net Worth
As of March 2009, Not Seasonally Adjusted, USD Billions



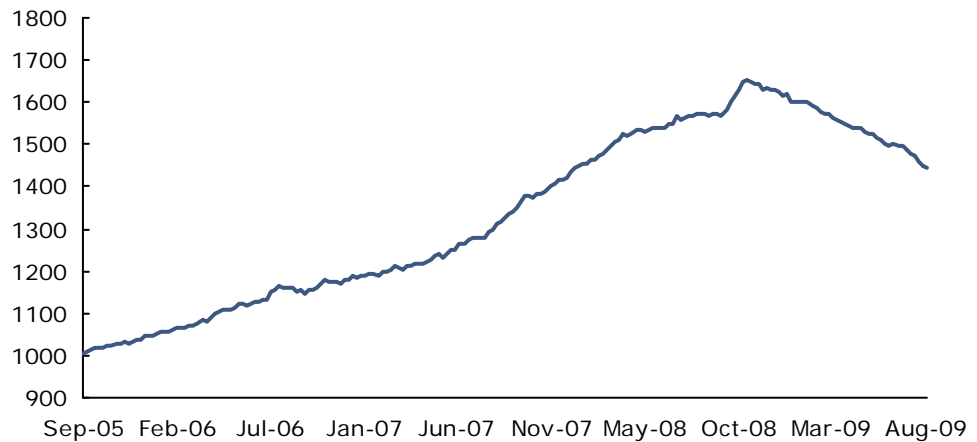
Sources: Federal Reserve, Haver Analytics

Chart 2

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Commercial and industrial loans outstanding are still shrinking:

Commercial and Industrial Loans in Bank Credit: All Commercial Banks
As of August 2009, Seasonally Adjusted, USD Billions

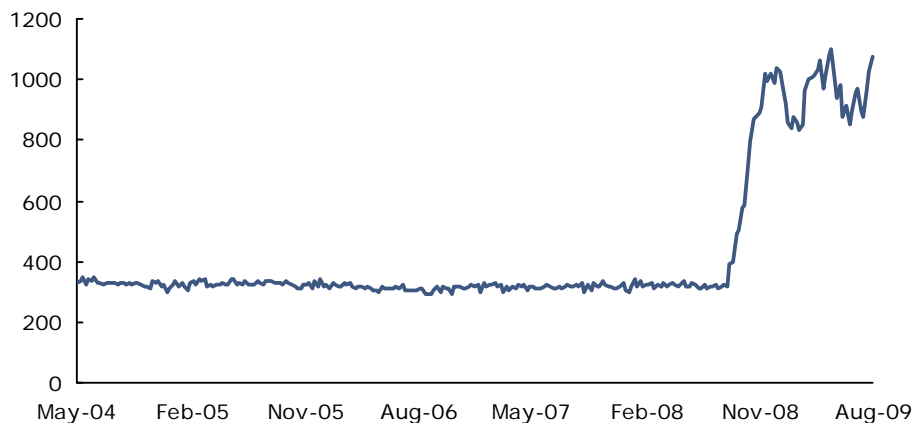


Sources: Federal Reserve, Haver Analytics

Chart 3

The velocity of money has plunged; banks are sitting on cash:

Cash Assets: All Commercial Banks
As of August 2009, Seasonally Adjusted, USD Billions



Sources: Federal Reserve, Haver Analytics

Chart 4

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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 market, interest-rate, issuer, credit, and inflation risk. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. 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.

The ISM Purchasing Managers Index (ISM PMI) is a composite index that is based on five major indicators including: new orders, inventory levels, production, supplier deliveries, and the employment environment. Each indicator has a different weight and the data is adjusted for seasonal factors. The Association of Purchasing Managers surveys over 300 purchasing managers nationwide who represent 20 different industries. A PMI index over 50 indicates that manufacturing is expanding while anything below 50 means that the industry is contracting.

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