

## Spotlight

May 2007

### Chris Dialynas Discusses PIMCO's Upcoming Secular Forum



#### Chris P. Dialynas

Managing Director, Portfolio Manager and Senior Member of PIMCO's Investment Strategy Group

Mr. Dialynas joined PIMCO in 1980. He has written extensively and lectured on the topic of fixed income investing. He served on the Editorial Board of The Journal of Portfolio Management and was a member of Fixed Income Curriculum Committee of the Association for Investment Management and Research. He has twenty-five years of investment experience and holds a bachelor's degree in economics from Pomona College, and holds an MBA in finance from The University of Chicago Graduate School of Business.

*PIMCO's quarterly Economic Forums are designed to allow all PIMCO investment professionals to participate in the firm's global economic and investment forecasting. Three of the Forums focus on the six to twelve-month Cyclical Outlook while the May Secular Forum focuses on the three to five-year outlook. In the interview below, PIMCO Managing Director Chris Dialynas discusses the major themes for this year's Secular Forum in May.*

#### **Q: When PIMCO professionals get together in May to formulate the firm's three to five-year Secular Outlook, what major themes will carry over from the prior year's Forum conclusions?**

**Dialynas:** Globalization will remain the major theme, as it has for the past five years at least. Certainly, globalization includes a number of categories, including the state of global liquidity, trade and investment imbalances, regulatory impacts on trade, energy prices and the interdependence of regional economic growth. All of these are very important pieces of the secular puzzle, and all play a key role in PIMCO's Secular Forum dialog.

At the last Secular Forum, we started to identify a turning point in the global compression of risk premiums we had seen over the last several years. As we expected, an increase in risk premiums did not start in every sector at once - it started with the weakest credits. We saw turmoil in the U.S. subprime mortgage sector that we believe is just a first step in repricing many types of risk over the secular horizon. Though the subprime problems happened in a relatively short period of time, the tightening in credit that they foreshadow will be a secular phenomenon.

Another secular topic that carries over from the last Forum will be global imbalances. At the last Secular Forum, we determined that the major trend – the buildup of current account surpluses in the developing world and the growing deficits in the developed world – will continue. They moderated somewhat over the past year because the U.S. growth rate has fallen so much, but the trend is toward further imbalances. However, the situation is evolving and includes different players. Due to high energy prices, the distribution of global reserves is no longer limited to Asian producers of consumer goods; it is also going to producers of crude oil. This means that there is a broader distribution of

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dollar reserves, and a broader taste for global investments that PIMCO must watch and forecast.

**Q: If imbalances are becoming more distributed around the globe, is China's role in the Secular Forum discussion as important as it has been in recent years?**

**Dialynas:** Yes. Any discussion of global imbalances will include China, which is the world's largest holder of U.S. dollar reserves. But the China discussion will go beyond surpluses and deficits. In fact, some might go as far as to suggest that China has become the secondary, or even the primary, engine of global growth. This is the largest example of how linkages in the global economy are changing, and PIMCO's Secular Forum debate will aim to identify if and how traditional couplings between growth in the U.S. and other countries are beginning to break down.

China will also be at the heart of the debate over the future of Bretton Woods II, the unwritten agreement in which the U.S. can maintain a large current account deficit as long as foreigners keep investing back in the U.S. The common presumption is that Bretton Woods II is in every country's mutual interest to keep the globalization game going. But as this arrangement grows, it becomes more complicated and makes more people nervous. We've seen that the Bush Administration has been unable to convince China that it needs to revalue its exchange rate. From the U.S. standpoint, a revaluation is an obligation under Bretton Woods II, since it could help cure some of the imbalances or at least keep them from growing too large. But China has been very reluctant to let its currency appreciate significantly. The exchange rate has appreciated 3% to 4% versus the dollar over the course of the past year, whereas the euro has appreciated about 10% and the Indian rupee around 7%.

**Q: Could the Secular Forum debate explore whether Bretton Woods II is becoming too large to be sustained?**

**Dialynas:** Partly because of China's reluctance to move on currency policy, imbalances will grow and increase the scope of Bretton Woods II. At some point the construct of Bretton Woods II itself starts to become more of a threat – this is increasingly part of the secular debate. The natural assumption is that the longer the game is played, the more independent China becomes and the more dependent the U.S. becomes. At some point, the only recourse that U.S. policymakers would have is to move toward trade restrictions. The debate, then, will be about whether regulatory intervention is a realistic and effective measure, and what unintended side effects trade restrictions would cause.

So the issue for PIMCO is to determine what the investment objective function is for any one country under Bretton Woods II. But we also have to gauge the utility function for each country and identify how it will vary over time. If countries stop seeing the utility value of holding so many dollars, they will likely move into other currencies. This is part of the diversification story, and a crucial discussion for PIMCO because we are a global bond firm.

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**Q: PIMCO's last Secular Forum concluded that the dollar is in a secular decline. Will the secular outlook be influenced by its sharp recent declines versus the euro and other currencies?**

**Dialynas:** The dollar has fallen pretty well over the course of the past year, a move that has been cyclical in scope. PIMCO's view, however, is that the dollar is in a long-term secular decline. At the upcoming Secular Forum, we will likely maintain this outlook, but there will be discussion about how the short-term movements in the dollar affect our long-term view of where it is headed.

**Q: The U.S. housing market and subprime mortgages have been a big part of PIMCO's Cyclical Outlook. Are there longer-term secular implications of the subprime crisis?**

**Dialynas:** I do think we will identify subprime as a secular topic, not in the sense that subprime mortgages themselves will be a three to five-year issue, but in the sense that it seemed to mark the beginning of what will likely be a long-term tightening in lending standards. The question becomes "how did we create the subprime problem and what other problems did we create in the same fashion?"

Bill Gross has often talked about the "asset pump." The idea is that if you can drop the discount rate low enough, you can inflate the value of assets and increase the perception of wealth and keep the recovery going. It appears that occurred globally in the past three or four years, and the U.S. housing market in particular was inflated by the combination of easy monetary policy and creative financing. Now that U.S. housing is in decline, there is a big debate about whether it is a cyclical phenomenon or a secular phenomenon.

From the secular point of view, the debate will focus on how far asset prices and markets will have to shift as we go from extremely liberal credit standards to a secular tightening of standards. This debate is not only applicable on a secular basis to housing, but also to general financing of the capital market as it relates to structured products, credit default swaps and leveraged investing.

**Q: One of PIMCO's guest speakers focuses on geopolitical and military developments in the Middle East. From an investment strategy standpoint, why examine this issue?**

**Dialynas:** We think the Middle East is important from several points of view, some of which are more directly linked to our economic outlook and others which have indirect links. On the direct side is the price of oil, which weaves its way into many of the Secular Forum issues including global dollar reserves, investment, consumption, inflation and ultimately economic growth. There are also direct links when we are talking about the war in Iraq, since our ongoing presence in Iraq will directly affect the U.S. federal budget deficit. In essence the U.S. is financing the war by borrowing from trade surplus countries of the world, which is different from the traditional domestic financing of wars. Americans are able to consume at the same time that we've been fighting a war, which makes historical comparisons less applicable. A more subtle implication is that financing the war through the trade deficit means that our children are the ones who will end up paying for the war, which will affect the super-secular outlook.

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On the indirect side, the security issues of being at war, not only in Iraq but against a regionally diversified global terror threat, are hard to predict but could have a large impact on the U.S. and global economy. This leaves a de facto tail risk in place that attacks on the U.S. or Europe or in other places could cause ripples through financial markets, though we believe that global policymakers are aware of the risk and would most likely respond to stabilize markets.

**Q: Thank you, Chris.**

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