

Spotlight

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Bill Gross Discusses PIMCO's Global Outlook and Strategy for 2008



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Mr. Gross is a founder and Managing Director of PIMCO. He is the author of numerous articles on the bond market, and has appeared on CNN, CNNfn, CNBC, Fox Financial News and Reuters. Morningstar elected Mr. Gross as their 1998 and 2000 Fixed Income Manager of the Year. In a survey conducted by *Pensions and Investments* magazine in 1993, Mr. Gross was recognized by his peers as the most influential authority on the bond market in the United States. He has 38 years of investment experience and holds a bachelor's degree from Duke University and an MBA from UCLA Graduate School of Business.

Bill Gross is PIMCO's Chief Investment Officer, one of the firm's founders and the author of the monthly Investment Outlook. In the interview below, Mr. Gross discusses PIMCO's outlook for 2008. A table summarizing PIMCO's 2008 forecasts can be found at the conclusion of the interview.

Q: What is PIMCO's outlook for U.S. growth in 2008?

Gross: U.S. growth in 2008 will primarily depend on the direction and level of U.S. housing prices, and on the effectiveness of the Fed's response to weakness in housing. Housing prices are down 5% nationwide already, and could perhaps decline another 10% over the next several years. The 2008 outlook for housing prices will be a function of whether the Fed can cut off a worst-case scenario, but we think continued weakness in housing and slower economic growth are already baked into the cake for next year. U.S. GDP growth should average about 1% in 2008, with personal consumption expenditure inflation averaging about 1.9%.

Q: How low does the Fed need to cut rates in 2008?

Gross: The Fed will likely need to cut the Fed Funds rate to 3% or lower in 2008 to restart a near-recessionary U.S. economy. The Fed cannot afford to see housing prices go down by 15% or 20% – that is an asset deflation of significant proportions – and so the Fed needs to allow future homeowners to be able to purchase homes. The way to do that is to lower the cost of financing. Our best estimate as to the Fed Funds rate that would allow a future homeowner to afford a home is somewhere around 3% or perhaps even lower. That would produce a 30-year mortgage rate of about 5% to 5.5%, which should allow reflation in the housing market to begin.

We've already seen an increase in mortgage refinancing, and the lower the 30-year mortgage rate goes, the more it promotes refinancing and the more it makes housing affordable. That combination will help to stabilize the economy over the next several years, though it is too late to prevent slower growth in 2008.

Q: In your December *Investment Outlook*, you write that we are witnessing the "breakdown of our modern day banking system". Will Fed rate cuts help to restore the banking system in 2008?

Gross: Shoring up the banking system may require more than cheap financing or bailouts of structured investment vehicles (SIVs). The banking system is a lot different than it was five or 10 years ago when individuals put money into a bank. In the last few years, the search for higher returns has allowed unregulated hedge funds and financial conduits to

Spotlight

December 2007

grow into a “shadow” banking system built on leveraging and cheap financing. We need to see a return of confidence in this shadow banking system.

Those financial conduits, supported by a trillion dollars of asset-backed commercial paper, were constructed on the basis of AAA ratings that suggested these investments could never fail. As the subprime crisis undermines these structures and investors’ confidence in them, it is a stretch of the imagination to suggest that 100 basis points of interest rate cuts by the Fed will restore confidence. So the situation is really one in which you have to shore up the financial system in its modern form rather than its old form. That will require substantially lower interest rates, but it will also likely require other steps as well.

Q: The Fed and other central banks recently announced a coordinated effort to improve liquidity by auctioning \$40 billion in loans to the market. Will this be enough?

Gross: This was a good move on the part of the Fed. Lending through the discount window to restore liquidity was not working, so they have essentially opened a new discount window that will allow hundreds of banks to participate. That will ultimately help to lower the 30-year mortgage rate, which is the key to the entire economic puzzle. The current size of the loan program may not be sufficient, but if this does not succeed, I expect the Fed to increase the size until it does. So I give the Fed credit for coming up with an innovative measure, although more may be needed in terms of size.

It is also important to understand that this is a re-insurance policy on liquidity, not risk assets. If we are to see a return of risk appetite, the market will ultimately have to step up, and policymakers may also need to take additional steps as well. For example, Congress could increase the limit for conforming mortgages from the current \$417,000 to \$1 million, as Fed Chairman Bernanke has already suggested. Housing programs resembling those of the 1930’s FDR administration may be required.

Q: On a secular basis, PIMCO expects strong global growth over the next three to five years as the global economy decouples from the U.S. economy. What is PIMCO’s forecast for global growth in 2008 given the developments in the financial markets and the U.S. economy?

Gross: We continue to expect strong global growth over the secular horizon and our global base case forecast is for a soft landing in global growth in 2008, with some degree of decoupling of growth from the United States and with relatively stable inflation. But our confidence in a global soft landing for 2008 has declined with the developments in the financial markets. While business cycles are decoupling, the global capital markets are increasingly coupled, creating a mechanism for contagion to spread from the U.S. to the global economy.

The global commercial paper market is shrinking by hundreds of billions of dollars a month. Credit contraction and asset destruction are spreading like a disease around the world. So central banks worldwide are facing a giant stress test of the modern-day shadow banking system. The Bank of England has now begun to cut rates and the European Central Bank should eventually follow suit in 2008.

Because of the contagion from the financial markets, we have lowered our forecast for growth in the UK and Europe for 2008. Real GDP growth will probably average about 1.8%

Spotlight

December 2007

in the UK and 1.9% in the euro zone for 2008. We also lowered our growth forecast for Japan, where we expect real GDP to average 1.2% in 2008.

Q: Where does PIMCO see opportunity heading into 2008 given the macroeconomic backdrop and the developments in the financial markets?

Gross: In an environment where almost all bonds are viewed with suspicion, we see value in some of the high-quality sectors of the market that have underperformed U.S. Treasuries.

Agency bonds and agency-guaranteed mortgage-backed securities (MBS) have been avoided due to billion dollar write-offs at Freddie Mac and Fannie Mae, and also due to rising supply as homeowners shift from adjustable-rate to fixed-rate mortgages and mortgage lending shifts from non-agency to agency MBS. Agency MBS in particular are extremely cheap, offering 150 to 175 basis points of extra yield relative to Treasuries. We think agency MBS spreads offer very compelling value and the potential for narrowing spreads when the market begins to differentiate between high-quality agency MBS compared to lower quality, non-agency MBS.

Swaps also provide an attractive yield pick up of 70 basis points or more relative to Treasuries, across almost the entire yield curve, even though swaps are very high quality instruments reflecting the rates at which the world's best banks lend to each other.

U.S. municipal bonds are another example of a bargain in today's market. Across the yield curve, high quality muni bonds now yield the same or more than Treasuries of the same maturity, and munis are exempt from federal taxes and most state and local taxes while Treasuries are for the most part taxable.

Q: What is PIMCO's outlook for the dollar and how is that influencing investment strategy?

Gross: We continue to think that the dollar will be weak going forward relative to emerging market currencies. It may have bottomed relative to the euro and pound sterling. Purchasing power is more likely to be enhanced via investments in strong, not weak, currencies, so we continue to favor selective non-dollar assets.

Q: Thank you, Bill.

Summary of PIMCO's Forecasts for 2008

	U.S.	Euro Zone	U.K.	Japan
GDP	0.75% - 1.25%	1.75% - 2.25%	1.50% - 2.00%	1.00% - 1.50%
Inflation*	1.75% - 2.25%	2.00% - 2.50%	1.75% - 2.25%	-0.50% - 0.00%
Other Key Forecasts:				
Fed Funds Rate (Dec. '08)		3%		
U.S. Housing Prices		-5% to -10%		
U.S. Dollar		Continue to Fall		

* PCE for U.S., CPI for Euro Zone, U.K. and Japan

Spotlight

December 2007

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The value of some mortgage- or asset-backed securities may be particularly sensitive to changes in prevailing interest rates. Early repayment of principal on some mortgage-related securities may expose a portfolio to a lower rate of return upon reinvestment of principal. When interest rates rise, the value of a mortgage-related securities generally will decline; however, when the interest rates decline, the value of mortgage-related securities with prepayment features may not increase as much as other Fixed Income Securities. The rate of prepayments on underlying mortgages will affect the price and volatility of a mortgage-related security, and may shorten or extend the effective maturity of the security beyond what was anticipated at the time of purchase. If unanticipated rates of prepayment on underlying mortgages increase the effective maturity of a mortgage-related security, the volatility of the security can be expected to increase. The value of such securities may fluctuate in response to the market's perception of the creditworthiness of the issuers. Additionally, there is no assurance that private guarantors or insurers will meet their obligations.

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