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Doug Hodge Discusses Asian Investment Trends and Strategies



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Mr. Hodge oversees all aspects of PIMCO's business across the Asia Pacific region. Located in Tokyo, Mr. Hodge has senior management responsibility for PIMCO's four Asia Pacific offices, in Tokyo, Hong Kong, Singapore and Sydney. Mr. Hodge also served on the PIMCO Executive Committee, responsible for setting firm-wide business strategy and policy. Previously, Mr. Hodge was a senior account manager responsible for client relationships worldwide and a global product manager. Mr. Hodge joined PIMCO in 1989, formerly having been associated with Salomon Brothers where he was a global fixed income trader. He has twenty-one years of investment experience, and holds a bachelor's degree in economics from Dartmouth and an MBA from the Harvard Business School.

PIMCO Managing Director Doug Hodge oversees all aspects of the firm's business across the Asia Pacific region. In the interview below, Mr. Hodge discusses the challenges Asian bond investors face in today's market and the opportunities PIMCO sees that may help investors meet those challenges.

Q: As you travel around Asia speaking to bond investors throughout the region, what are the biggest challenges they face right now?

Hodge: Bond markets around the world are obviously in a great state of flux right now given the meltdown in U.S. subprime mortgage loans and the resulting concerns about credit exposure. But universally, the challenge for Asian bond investors in recent years has been achieving returns that can keep up with the returns in the equity markets. In most of the countries across Asia, economic growth has been very strong, with China being the most obvious example. In a growth economy where liquidity is plentiful, investors have had a natural disposition towards risk-taking because that is the kind of environment where risk-taking is rewarded.

The bond market itself has also presented challenges. Longer-term bonds have been yielding little more than cash rates and non-government bonds offer very low yield pick-ups due to compressed risk premiums. That has prompted a move toward investment strategies such as hedge funds that focus on generating alpha, or enhanced returns, relative to the cash rate.

As a result, we have seen declining allocations to fixed income generally, and a preference for bonds at the higher end of the risk spectrum such as emerging market debt denominated in local currency or structured products backed by some of the things we are reading about in the paper today. Asian financial institutions hold a lot of these structures on their balance sheets or in off-balance sheet vehicles. Reducing exposure to some of these structured products will be a challenge now and in the future.

Q: How are Asian investors likely to react to the growing concerns about credit exposure?

Hodge: One of the characteristics of the current credit crunch is that investors who provided liquidity in credit markets have pulled back. Asian investors were significant providers of liquidity and in many cases they have retrenched. With the meltdown in

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subprime and the resulting credit crunch, I think investors will have a better understanding that risk is a double-edged sword and that prices can not only go up but they can also go down. The appetite for higher quality bond products is going to reemerge just as it did after the Asian debt crisis, just as it did after the NASDAQ meltdown. We are in another one of those periods in the cycle where more conservative risk-taking is going to be the order of the day. If the global economy slows and central banks begin to cut interest rates, then I think we will see renewed appetite for longer-term bonds as yield curves steepen and term premiums return to the long end of the yield curve.

Investors are also likely to take a more rigorous look at their alpha strategies, and I think what many will find is that much of what has been advertised as alpha is really just beta, or market risk, disguised as alpha. Sometimes that shows up when markets are rising and returns are strong, but it becomes crystal clear when things reverse.

Q: How does a bond investor with a reduced appetite for risk meet the challenge of achieving attractive returns from their bond allocation?

Hodge: We believe the immediate future for bond returns actually looks quite good. The next year or two will likely be defined by the housing crisis in the U.S. and how quickly the U.S. central bank responds by further cutting rates as they just have, and how other central banks follow if there is contagion from the U.S. housing sector to other parts of the global economy. So we see the potential for a continued rally in the short end of the yield curve, particularly in the U.S.

Longer term, PIMCO's secular view is that the global economy is pretty solid. If you compare the pricking of the U.S. housing bubble to other asset bubbles, one of the key differences is that we now have a significant cushion in terms of global growth, which has been around 4%. We see the world on a two-track process. We believe the emerging economies can continue to expand in the 8%-10% range led by China, whereas the developed economies will grow in the scope of 2%-3%. That is not to say that the rest of the global economy will continue to chug along if the U.S. experiences a significant slowdown. That is categorically not the case. But if you go back to where we were in 1999-2000 when the Long-Term Capital Management crisis hit, global growth was around 2% and Japan's growth was at zero. Today, we have a much different scenario, which is a good thing for the global economy.

In a secular environment of solid global growth, we could see interest rates rising over the longer term in parts of the world where economic growth has been so strong. That will be a bit of a challenge for bond returns. And so, for bond investors seeking attractive returns over the longer-term, we think the current period presents an opportunity to benefit from a cyclical rally in bonds as central banks cut interest rates and an opportunity to invest for the longer term in higher-yielding assets that are likely to benefit from secularly strong global growth.

Q: How does PIMCO see this transition playing out, from a cyclical slowdown to strong growth over the secular timeframe?

Hodge: On a cyclical basis, we have long believed that the U.S. housing market was the driver of the U.S. economy and that problems would arise when adjustable-rate and subprime mortgages reset into higher rates and housing prices stopped rising. Our

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view has been that problems in the housing sector would cause the U.S. economy to slow, which would also impact the global economy. Thus, the first leg of our cyclical forecast is now unfolding in real-time.

The next leg will be the transmission of the problems in housing into the broader economy, and the transmission mechanisms are the capital markets. We are now seeing that transmission mechanism at work. The question is: How significantly will this affect the U.S. economy? Does the U.S. consumer pull back? Do jobs become less certain? Does income growth slow compared to the last several years? All of those questions need time to play out and that has not happened yet.

Over the longer term, bond investors need to decide whether they want to behave like a central bank and buy the highest quality assets like Treasuries and triple-A rated mortgage-backed securities. Or, to borrow a phrase from Bill Gross¹, do they want to behave like Harvard and Yale, which are buying higher yielding assets?

At PIMCO, we want to behave more like Harvard and Yale over the longer term. And in the fullness of time, we plan to use opportunities created by this market dislocation to buy cheap assets that are being sold at distressed prices by hedge funds and other financial institutions around the world. This is the kind of environment where PIMCO is a provider of liquidity when others are not. And so, over the next year or so, we should be seeking opportunities to take advantage of the economic growth in Asia by purchasing assets that should benefit from Asia's growth at distressed prices.

Q: The mortgage meltdown and the resulting credit crunch have been in progress for some time now. Why do you expect this situation to create opportunities over the next year or so? Will it take that long for the markets to return to normal?

Hodge: Rating downgrades for subprime-backed bonds just started to occur in July and we believe this is only the beginning of a trend that could create opportunities for the next one to two years. The problems in the mortgage credit markets are likely to be prolonged for a couple of reasons.

First, even with central bank easing, the turmoil in the financial markets will take time to sort out. We have seen a dramatic reduction in the issuance of commercial paper. This short-term financing serves as a lubricant for the financial markets and for the credit creation process. So the decline in commercial paper issuance indicates a significant reduction in the willingness of financial institutions and others to lend on a short-term basis and a contraction in credit. When the markets went through a similar credit contraction following the Long-Term Capital Management crisis, it took six to nine months before the markets returned to what you might characterize as normal.

Second, housing cycles are usually elongated. Housing is an illiquid market, transaction costs are high and there is imperfect information. These are all aspects of a market that is not self-correcting and that takes a long time to return to the point of equilibrium where supply meets demand. Currently, the housing market suffers from excess supply whereas two years ago you could argue that the market suffered from

¹ See the May/June *Investment Outlook* by Bill Gross.

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excess demand. But the housing market has not found equilibrium and the time it takes to reach equilibrium will be measured in years rather than months. The stock market is far more efficient than the housing market, and it took the NASDAQ about two years to return to equilibrium after the technology bubble collapsed.

But the markets will return to normal eventually, as they always do. I think of these crises as comparable to when you are out in the surf and a big wave comes along and knocks you over. You are turned upside down and you lose your balance, but the one thing you do know is that you will wash up on the sand, the wave will wash out, and you will be left at the beach. The only thing you have to guard against is not drowning between here and there.

Q: What is PIMCO doing to capitalize on the opportunities in the Asian debt markets that you have discussed?

Hodge: We started trading Asian debt and Asian currencies in our Singapore office almost a year ago and the volume of activity has gone up almost exponentially. We also plan on adding more capability in Singapore and elsewhere in Asia because of the opportunities that we see developing.

The accumulation of wealth that is happening in Asia is largely the result of rapidly increasing current account surpluses and rising per capita incomes in places like China, India, Malaysia and Indonesia, which are among the most populous countries in the world. As these trends continue, the appetite for financial products will grow and more and more financial assets will be created as the banking systems in these countries become more developed and institutionalized. So we see investment opportunities for our clients as well as opportunities for PIMCO to offer both traditional and alternative financial products to a new class of investor in these economies. For example, the trend toward greater scrutiny of alpha is a welcome development because we offer alternative and absolute return strategies that we think meet the test of providing pure alpha rather than disguised beta.

Some of these opportunities will be driven by how well the Asian economies withstand slower U.S. growth and by the development of capital markets in Asia. People have been waiting a long time for the capital markets in Asia to develop and that process is really moving along right now. The process has been derailed a few times, most notably by the Asian debt crisis, but hopefully that will not happen this time despite what is going on in the U.S.

Q: Thank you, Doug. We look forward to speaking with you again soon about developments in Asia.

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