

## Global Deleveraging Likely to Lead to Worldwide Downturn

1st QUARTER  
2009

## Market Outlook

PIMCO expects pressures of global deleveraging to drive developed economies into one of the most severe recessions since World War II in 2009. Conditions should improve by 2010 as policy responses in the U.S. and elsewhere gain traction. Recovery of risk appetites in financial markets will be a leading indicator for recovery. A global depression, while possible, is a low probability outcome that policymakers will exhaust all realistic options to avoid.

■ **Financial Markets Likely to Recover Before Broader Economy** – Signs that policies

such as Federal Reserve liquidity injections and government support for the financial sector are gaining traction will likely come first from revival of risk appetites in financial markets. Valuations of many assets have fallen to compelling levels amid forced selling by over-levered investors. Moreover, a portion of the downside will now be covered by the government for investments in industries such as financial services, housing and potentially autos.

■ **Support for Financial Institutions** – In the U.S. and elsewhere the response to institutional risks posed by deleveraging has been assumption by governments of assets from troubled private banking sectors, in what amounts to creation of a government-sponsored private banking system. Establishment by the U.S. Treasury of a lending facility for asset-backed securities (auto loans, student loans and credit cards) is the latest example.

■ **Support for the Consumer** – Besides the institutional risks posed by deleveraging, the U.S. and other economies face the potential for a sharp reduction in consumer spending. Plans for substantial fiscal stimulus in the U.S., China and elsewhere should mitigate this risk and help prevent a collapse in consumption.

■ **Europe, the U.K. and Japan Also in Recession** – Investment and exports were the main drivers of the Eurozone's recent growth, but final demand in Europe will

not be insulated from the global credit crunch. The U.K. is even more vulnerable than Europe because of its higher consumer debt and the potential for a major real estate correction. The global financial crisis hit Japan through the rally in the yen, which hurt exports, as well as a fall in the Japanese stock market. With external demand the only potential growth engine, Japan's recession should continue through 2009.

■ **Headwinds for Emerging Economies** –

Major emerging economies such as Brazil, Mexico and Russia are not expected to contract but they will face strong headwinds as their exports to developed countries slow and credit markets remain restrictive. Weaker external demand will also help cool China's rapid expansion, though the Chinese government's plan for massive fiscal stimulus indicates that it will do what is necessary to prop up domestic demand.

■ **Inflation Subdued Over Cyclical Timeframe** –

Large and growing excess capacity as the economy weakens will fuel disinflation and may even create deflation for a time over the next year. While the Fed has injected huge levels of liquidity into the financial system, transmission of these reserves out into the broader economy has been constrained by strong demand for cash among financial institutions and consumers. Cash hoarding should help keep inflation subdued over a cyclical timeframe.

**Focus on Assets With Attractive Yields and Policy Support**

As the global economy weakens into 2009, PIMCO will place less emphasis on interest rate strategies and more on high grade sectors/securities that offer unusually attractive valuations after the massive selling of the last several months.

The PIMCO approach over the next year will be to avoid assets such as Treasuries that have benefitted from the flight to liquidity associated with global deleveraging. Treasuries are now

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overvalued. We will seek to own assets that have been victims of the economic crisis but that can be expected to benefit from policy support. These assets include high-quality mortgage-backed securities, bonds of financial companies, TIPS and municipal bonds. We will also shun assets that have been victims of the crisis but have no policy support, such as high yield and all but the highest quality emerging market bonds.

■ **Interest Rate Exposures** - PIMCO will target duration close to neutral with respect to the benchmark as interest rates are unlikely to fall much from current low levels. We will likely begin to lighten our exposure to strategies that may gain from yield curve steepening, focusing first on trimming such positions in the U.S. and then on the U.K., Europe and Australia as monetary conditions in these economies ease.

■ **Sector Exposures** - We plan to retain a substantial overweight to agency mortgage pass-throughs, which currently offer yields well above Treasuries. Their credit quality is close to that of Treasuries in light of expected government support associated with the conservatorship of Fannie Mae and Freddie Mac. Another major emphasis will be debt securities of financial institutions that are supported either by TARP capital, FDIC guarantees or access to the Federal Reserve's liquidity facilities.

■ **Tactical Allocations** - Assets that are relatively senior in the capital structure, such as TIPS and municipal bonds, represent prudent allocations at this stage in the economic cycle. TIPS offer an explicit government guarantee and relatively high real yields. Municipal bonds are currently priced at historically attractive yields versus taxable bonds with generally high credit quality.

PIMCO is not ready to venture into high yield corporate bonds. While these assets offer seemingly compelling valuations, their credit premiums could widen further as defaults surge amid the worldwide economic slowdown. With respect to emerging markets, we will look to add attractively priced high-quality credits such as Brazil and Mexico to our modest EM allocation as the credit recovery process continues.

■ **Currency Exposure** - PIMCO does not have strong conviction about the U.S. dollar over the cyclical horizon, so there will be minimal currency exposure in portfolios.

■ **Portfolio Structure** - Given the risks posed by financial market volatility and uncertainty, we will structure portfolios around the relatively small number of themes described in the foregoing.

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