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Tomoya Masanao Discusses PIMCO's Outlook and Strategy for Japan

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Mr. Masanao is Head of Portfolio Management in Japan. He joined PIMCO in 2001 as a global portfolio manager and has been based in Tokyo since 2003, managing global and Japan portfolios. Previously, Mr. Masanao was associated with Goldman Sachs Asset Management in London where he was an executive director and senior portfolio manager responsible for Japanese strategies. Prior to that, he was associated with Sumitomo Bank as a proprietary trader in London and a credit analyst in Osaka. Mr. Masanao has fifteen years of investment experience, and holds a bachelor's degree and a master's degree in engineering from Osaka University and an MBA from Boston University.

Tomoya Masanao oversees portfolio management in Japan. In the interview below, he discusses the conclusions from PIMCO's recent Cyclical Forum and how they apply to Japan's economy and bond market.

Q: PIMCO recently updated its global cyclical outlook at the firm's quarterly Cyclical Forum. What were the major considerations in determining the outlook and what did PIMCO conclude?

Masanao: A major consideration in our global cyclical outlook is the risk of contagion from the U.S. housing market. The question is how much the U.S. housing market turmoil will spread into other sectors of the U.S. economy and the global economy.

Our sense is that some contagion effect from U.S. housing, both in the U.S. and globally, is a strong possibility. Within the U.S., the fall in housing prices is likely to create a negative wealth effect. As housing prices drop, U.S. consumers will feel less wealthy and may spend less as a result. Mortgage payments are also likely to rise as adjustable mortgages reset at higher rates, and consumer confidence and employment should drop.

Beyond the U.S., the globalized financial markets create the risk of contagion for the global economy. As the recent episode of global credit market turmoil illustrates, the issue of off-balance-sheet financing through asset-backed commercial paper and structured investment vehicles is not contained to the U.S. The resulting credit crunch, which we think will occur through the traditional banking system, will be a global event.

While we continue to expect strong global growth over the 3-5 year secular horizon, we concluded that the global credit crunch and risk aversion in general should lead to slower growth over the next 12 months, not just in the U.S. but in other developed economies as well, especially where housing has driven domestic demand as in the U.K. and Australia.

Q: On a secular basis, PIMCO expects global growth to be less dependent on the U.S. consumer. How are recent cyclical developments influencing the firm's expectations about this decoupling trend in global growth?

Masanao: Over the secular horizon, we still believe global growth is decoupling from U.S. growth. Global growth should remain strong at 4-5%, driven primarily by strong growth in the emerging markets that will offset slower growth in the U.S. and other developed countries. On a cyclical basis, though, the secular global decoupling theme will be challenged as the turmoil in housing and credit markets intensifies, U.S. economic growth slows to below 2% and the risk of a U.S. recession increases.

Q: What do these global trends mean for Japan's domestic economy?

Masanao: Japan's growth has benefited from the secular decoupling theme as exports have gradually transitioned away from the U.S. and toward the rest of Asia and other emerging markets. Last year, Japan's non-US exports grew to 64%, with exports to Asia accounting for 48%. Much of the demand among emerging markets in Asia and globally is for infrastructure development, which means that Japan now exports more capital and production-related goods, which are 75% of all exports, than consumer goods.

Export data confirm that the global decoupling trend and its benefits for Japan were in place until this summer. However, as I mentioned earlier, the secular decoupling theme is being challenged by cyclical trends and the most recent data already suggest a deceleration of Japan's overall export growth.

So what does this mean for Japan? Japan's economy still relies heavily on external demand. On domestic demand, while household consumption has been weak, corporate investment has been firm and become a multi-year investment boom. But corporate spending from manufacturers and exporters is largely a function of external demand rather than domestic demand. As the global economy slows, exporters' top-line growth should slow and their "animal spirits" should also wane. The strengthening of the yen from super-cheap levels will be another serious drag on exporters' corporate profits, which will slow their investment.

In sum, we expect Japan's economy to grow at 1.25%-1.75% over the next 12 months, which is the low side of the economy's growth potential of 1.5%-2%. We also expect inflation of negative 0.5% to 0%, with structurally weak wage pressure.

Q: How does PIMCO expect the changes in the cyclical environment to influence interest rates? Can the Bank of Japan continue to raise rates with the U.S. Federal Reserve having shifted to rate cuts?

Masanao: We expect central banks in the developed countries to focus more on the threats to economic growth than the near-term concerns on inflation. The Fed has led the way by shifting to easing policy, but other central banks have at least paused, including the Bank of Japan (BoJ).

Governor Fukui's term at the BoJ will end in March 2008, and we expect the BoJ's journey to "normalize" short-term rates from zero percent will be on hold at the current policy rate of 0.5% at least through March 2008. We acknowledge the BoJ's strong "wish" to "normalize" the policy rates and expect the bank to continue trying to take any window of opportunity to hike rates. But we believe that, at the end of day, the economic data will matter, no matter what the BoJ's "wish" is. The global economic growth and inflation, and market environment that PIMCO forecasts in our cyclical horizon will not be as friendly as the BoJ expects to see. The Fed policy also matters to the BoJ. PIMCO expects the Fed to lower the Fed Funds rate to below 4% in 2008. We believe it is highly unlikely that the BoJ tightens its monetary policy when the Fed is aggressively cutting rates, as yen appreciation would otherwise accelerate a lot more and put huge deflationary pressure on Japan's economy.

There has been a sign of domestic demand slowing as well, which should be another reason for the BoJ to stay on hold. Housing has plunged since the summer, not because of the U.S. subprime turmoil but because of domestic legislative changes in the housing approval process. Changes in the construction law to make housing and buildings more earthquake-compliant have tightened the approval process and created a supply bottleneck. The law changed in June of this year, so we just started to see the negative impact of this change in the data. Housing starts fell 23% in July, 43% in August and 44% in September on a year-over-year basis. While the drop is supply-driven, not demand-driven, the collapse in housing and its potential ripple effects such as slowdown in durable goods consumption could continue for the next few quarters and weigh on the BoJ's policy decisions.

Q: How is PIMCO incorporating these views into its investment strategy? Could you start with your global strategies first?

Masanao: Globally, our investment strategies fall into four different themes. The first is that central banks are shifting to rate cuts or at least pausing in their tightening campaigns. This theme suggests strategies that should benefit from falling interest rates, particularly in the front-end, and steeper yield curves. It also suggests a weaker U.S. dollar as the Fed leads the shift toward rate cuts.

The second theme is that cyclical factors, including the subprime meltdown and the resulting credit crunch, have caused risk premiums to normalize from very low levels, especially in the corporate bond market where we have seen spread widening. So we are opportunistically adding corporate bonds.

The third theme is the secular decoupling of emerging markets from growth in the developed world, which should lead to a gradual increase in inflation over the long term. While the cyclical environment threatens this theme, we ultimately conclude that secular decoupling will continue, which favors emerging market assets and currencies, as well as inflation-linked bonds.

Our fourth theme is the contagion risk I discussed earlier. We have already seen contagion from U.S. subprime in the global money market, with LIBOR rates underperforming the rally in government bond rates. We think this relationship between LIBOR and government rates will normalize eventually, so we are overweighting swaps, which are LIBOR-based, versus government bonds, particularly in the front-end of the U.S. and European yield curves.

Q: How are you applying these strategies in Japan's bond market specifically?
Masanao: In Japan, we are favoring longer duration strategies and curve steepening strategies, in keeping with our first global theme. In particular, we are favoring the intermediate part of Japan's yield curve, which we expect to outperform other areas of the curve as the market prices out any expectation of BoJ's near-term monetary tightening.

We see good values in inflation-linked Japanese government bonds based on our expectations for a longer-term increase in global inflation. The breakeven inflation (BEI) rate priced into 10-year linkers is below 0.4%, which we think is extremely cheap as a long-term investment while acknowledging that near-term upside may be limited with our cyclical forecast of low inflation. We view that the current level of BEI has discounted the low inflation for our cyclical horizon but it has not discounted the higher inflation in the last half of the secular horizon that we are expecting to happen globally. Japan's inflation-linked bonds can also benefit directly from energy price appreciation, which we forecast in our secular horizon, as their underlying inflation measure, or Core CPI, includes energy components. Consumption tax hikes from a current very low level of 5%, which we expect to happen in our secular horizon, would also push up Core CPI if they indeed happen.

We are constructive in the corporate bond market globally, where risk premiums have more or less normalized. In the Japanese market, we continue to find Japanese bank capital paper attractive because spreads in this sector widened mostly in sympathy with U.S. and European bank paper, and widened more than the fundamentals in the sector suggest. The Japanese banks are much, much less exposed to U.S. subprime mortgages and to the U.S. asset- and mortgage-backed securities markets than the U.S. and European banks. So with spreads wider than fundamentals suggest, we see a good buying opportunity. However, we do not think we have seen the peak in credit spreads yet, so we are going to continue to be cautious and opportunistic in our security selection.

Commercial mortgage-backed securities are another potential buying opportunity in the Japanese credit sector. Here again, spreads have widened more than fundamentals suggest. We feel that the secular decline of the Japanese real estate market has already ended, and we are constructive on Japan's real estate market over the long term. We would actually use the recent spread widening to buy opportunistically.

Q: What is PIMCO's view on the Japanese yen?
Masanao: Our fundamental view on the yen is neutral. Our investment theme with regard to currencies is to underweight the U.S. dollar, and it is more attractive to do that versus emerging market currencies than the major currencies, including the yen.

That said, we believe in any major event in the market, the yen is more likely to appreciate than depreciate. Yen has been used as a favorite funding currency for so-called “carry trades”, which will be forced to unwind in any major event that makes investors risk-averse. In terms of direction, we think that the yen is likely to appreciate as investors become more risk-averse and try to unwind the so-called yen carry trade. We may opportunistically take a long position in yen, particularly for the accounts which cannot express our flight-to-quality bet through other favorite instruments such as Eurodollar futures.

Q: Thank you for discussing PIMCO’s cyclical outlook for Japan.