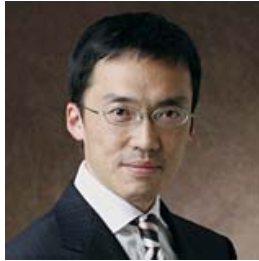


Q&A
July 2007

Tomoya Masanao Discusses PIMCO's Secular Outlook and Strategy for Japan



Tomoya Masanao
Executive Vice President

Mr. Masanao is an Executive Vice President and 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 is the head of portfolio management for PIMCO Japan. In the interview below, Mr. Masanao discusses the conclusions from PIMCO's recent Secular Forum, an annual event that brings the firm's investment professionals from around the world together to discuss the global outlook for the next three to five years.

Q: PIMCO recently held its annual Secular Forum to formulate the firm's global outlook and strategy over the next three to five years. Would you give us an overview of the main conclusions from the Forum?

Masanao: One of PIMCO's conclusions from the Secular Forum is that global growth, including emerging market economies, is going to be 4-5% over the next three to five years. This high level of global growth compares to 2-3% growth in the developed countries, so 4-5% global growth is going to be primarily driven by emerging market economies as opposed to developed economies.

We now believe that global aggregate demand will be less dependent on U.S. consumption because of the growth in emerging markets. As the emerging markets become an increasingly important driver of global aggregate demand, the rest of the world will benefit from emerging market growth, particularly Japan and European countries. For instance, infrastructure demand in emerging Asia, Russia and the Middle East, will fuel growth in developed countries that maintain heavy industry, particularly Germany and Japan. So that is working as a reflationary force in old-economy countries like Germany and Japan.

Another important conclusion from the Secular Forum relates to the evolution of currency reserves in major parts of the world economy. Currency reserves in China and other Asian countries have been a very important factor in containing risk premiums in the financial markets. These countries have been using their reserves to buy U.S. Treasuries and other high quality bonds in an effort to maintain currency pegs versus the U.S. dollar. That, in turn, has had the effect of reducing term risk premiums in the U.S. bond market and also, to a lesser extent, other global bond markets. This reserve reinvestment helped to contain not only term premiums but also volatility and risk premiums in credit and other markets.

Q&A

July 2007

That dynamic is evolving over our secular horizon, as highlighted by the recent example of China investing in a private equity firm. Countries with huge currency reserves are likely to allocate a portion for longer-term investment (so called “sovereign wealth funds”) and to invest it in assets that are riskier and offer higher return potential than bonds. This evolution is already occurring and will accelerate over our secular horizon.

This evolution, coupled with our global growth outlook, suggests a positive environment for riskier assets, notably stocks, real estate and commodities. That environment is unfortunately not very positive for high quality bond markets like U.S. Treasuries.

Q: Global inflation has been relatively contained despite strong global growth. Does PIMCO expect global inflation to remain contained over the next three to five years?

Masanao: We think inflation will be contained over the cyclical timeframe, which is the next six to 12 months, but expect modestly higher inflation toward the end of our three to five year secular horizon. The change in the driver of the global economy from developed to developing countries, which demand more commodities and other natural resources, is inflationary in and of itself.

We also think the integration of workers in China and other emerging markets into the global labor supply, which has been an important disinflationary force, will be less disinflationary going forward. Simply put, labor is going to have more pricing power in China and other Asian economies. While the first half of the migration in China’s workforce from rural areas to cities was disinflationary, the second half of that migration will, at the margin, be less disinflationary.

Q: In recent years, PIMCO has expressed concerns about the global economy’s vulnerability. Why is PIMCO more confident about the sustainability of global growth following this year’s Secular Forum?

Masanao: One important change in our outlook is simply that we recognize global aggregate demand is becoming less U.S.-centric and that domestic demand in emerging markets is continuing and accelerating, which in turn is feeding growth, particularly in Europe and Japan.

A second factor that led us to a different conclusion this year is the recognition that the higher asset prices, tighter credit spreads and lower bond yields we have experienced in the last three to five years have eased financial conditions globally. This global liquidity has largely offset central bank tightening in developed countries like the U.S.

As a bond manager, we perhaps tend to view the global economy as a glass that is half-empty. At this year’s Secular Forum, we tried to look at the world from a different perspective, and concluded that the glass is also half-full.

Q: How is PIMCO’s global secular forecast shaping the firm’s views on Japan specifically?

Masanao: We believe global growth of 4-5%, led primarily by emerging economies, is inflationary rather than deflationary for the Japanese economy. Japan primarily exports

Q&A

July 2007

capital goods and production goods. If you look at numbers for last year, more than 70% of Japanese exports are either capital or production goods, rather than consumption goods, and are mostly destined for Asia, Europe and the Middle East. In other words, infrastructure demand in the emerging market economies continues to fuel Japan's heavy industry, helping to offset a cyclical decline in U.S. demand for consumer goods, notably Japanese autos.

Q: How does China's continued economic growth affect the outlook for Japan?

Masanao: Some would argue that China is in competition with Japan, and therefore China's growth will be negative for the Japanese economy. That notion would probably be right over the very long-term horizon, but for the next three to five years, I do not believe that would be the case. The data show Japanese exports are more complementary to China's than competitive, whereas other Asian countries such as Indonesia, Thailand and Korea are in direct competition. In that sense, Japan is in a position to enjoy the global demand for China's exports, which should be supportive for Japan's reflationary story.

Q: How about Japan's aging population trend? How does the demographic trend affect the outlook for Japan? Is there any significant implication for asset prices?

Masanao: I would actually be cautious about the demographic argument for slower growth in Japan over the next three to five years versus the super long-term. The deteriorating demography will lower Japan's potential growth over the super long-term horizon, other things being equal. But over the next three to five years, the most important factor will be the impact of the baby boomers' retirement on Japan's labor force. The baby boom retirement is not just a Japan phenomenon, but the effect will be the most profound in Japan because of the demographic distribution of Japan's labor force, where baby boomers are more distinct than in any other developed country.

As the baby boomers retire, Japan's labor force is expected to decline by about 0.5% per year over the next five to seven years. That is likely to tighten the labor market and the unemployment rate is likely to fall even farther, probably to the low 3% range, which is low enough to produce inflation if you look at the historical relationship between employment and inflation. However, we expect the inflationary impact of this demographic shift will be only marginal. While the labor force will decline, corporations are still going to have pricing power over labor and corporations are going to be able to reduce overall labor costs because the baby boomers—one of the most expensive pools of labor—will be dropping from the labor force. Thus, the net effect of baby-boomers' retirement will probably be inflationary, but only slightly.

Demographic factors also have important implications for asset prices. In most corporations in Japan, employees get a large lump sum retirement bonus when they retire and compensation tends to be seniority-based rather than merit-based. Thus, the distribution of household financial wealth in Japan is skewed toward retired people. Those who are 60 or older hold more than 70% of Japanese net household wealth. So as the baby boomers retire and get lump sum payments in the next three to five years, we think a large pool of money will be invested in financial markets for their retirement needs. That is positive for asset prices, including stocks and non-yen financial markets, both equities and bonds.

Q&A

July 2007

Considering the extremely low real rates in Japan versus the expected higher returns on riskier assets in an environment of 5% global growth, it is very rational for households, and corporate investors as well, to try to shift their funds from bank deposits to risk assets or in some cases, even borrow money and invest in riskier assets, including stocks and foreign assets. So once again, the global goldilocks scenario is positive for risk assets globally and in Japan as well.

Q: The Bank of Japan (BoJ) is working to normalize short-term interest rates. How is the secular outlook likely to influence the BoJ's path towards normalization and thus the outlook for interest rates in Japan?

Masanao: These secular considerations increase the likelihood that the BoJ will be able to normalize its super-easy monetary policy over the secular horizon. The BoJ has been running a very low interest rate policy, with the overnight call rate currently at 0.5%. Given Japan's potential growth rate of 1.5% to 2.0%, and the BoJ's definition of "price stability" between 0% and 2% (or 1% median) CPI inflation, the neutral nominal policy rate should be around 2.5% to 3%. That is obviously much higher than the current policy rate, so the BoJ will likely continue trying to raise rates, as long as there is a window of opportunity for them to do so.

What does PIMCO's secular outlook mean to the BoJ's policy path? Our secular forecast of a Goldilocks global economy and mild inflation is favorable for the BoJ's policy normalization. Asset prices also play an important role in BoJ policy, and our secular outlook on asset prices should be positive for the BoJ.

Another important consideration is fiscal risk. The Japanese government is running a huge fiscal deficit, which is one reason for the steep yield curve in Japan's bond market. Given the very long-term demographic picture I just discussed, the Japanese bond market will continue to price in a high fiscal risk premium. But on the margin, if we are right on the global Goldilocks economy and its reflationary benefits for Japan, we think the fiscal risk premium will be lower rather than higher.

Q: Where does PIMCO see opportunity in Japan's bond market given the firm's secular outlook?

Masanao: Global bond yields are highly correlated and Japan is no exception. As global yields rise, so will yields in Japan. However, we believe inflation in Japan will be only marginally higher over the secular horizon, and certainly not as high as inflation in other developed economies. Thus, we think Japanese government bond (JGB) yields will rise, but not as much as bond yields in other developed economies.

That said, BoJ monetary policy is in a different cycle than other major central banks. The BoJ just started normalizing monetary policy from super easy, whereas the U.S. Fed, the European Central Bank and Bank of England have already normalized policy rates to neutral levels and probably gone beyond those levels in some cases. This implies a different outlook for the shape of Japan's yield curve versus other major yield curves. Since we now see a higher chance of the BoJ normalizing its policy as an implication of our secular outlook, we will look to position portfolios for a flatter curve in Japan than we would in other markets, where we think curves will steepen. In addition

Q&A

July 2007

to central bank policy normalization, our expectation of a lower fiscal risk premium and low potential growth over the super long term should provide fundamental supports for the long end of the curve. Finally, we also expect technical support for the long end from insurance companies seeking to hedge their long-term liabilities.

In terms of duration, we expect 10-year JGB yields to range from 1.5% to 3% over the secular timeframe. We think JGB yields will become attractive when they near the top of that range given our low expectations for inflation in Japan relative to the rest of the world. Japan also has the steepest yield curve among the developed countries, which provides good carry in a portfolio.

The JGB market has also not been a direct beneficiary of Asian central bank buying, as opposed to the U.S. Treasury market. Thus, we think the evolution in the management of central bank reserves that I discussed earlier will have less of an impact on the JGB market, which is another factor suggesting JGBs could perform relatively better amid any global bond market sell offs.

Q: Considering the secular outlook for Japan's exports and industrial sector, does PIMCO see opportunity in corporate bonds or other sectors of the bond market?

Masanao: Credit spreads are tight globally and Japan is no exception. Japan's corporate sector is fundamentally sound and balance sheets have improved, but since spreads are so tight, we expect to continue to underweight corporate bonds. That said, we continue to find Japanese bank capital and global bank capital attractive.

In addition, we expect to favor riskier assets and real assets over the secular timeframe, consistent with our view that the global secular trend favors more equity-like investments. In that regard, we also like commercial mortgage-backed securities, or CMBS, both in Japan and globally. As you know, Japan experienced a real estate market bubble in late 1980s. Since then, property prices have been dropping. But in the last few years, that situation has been changing. Nationwide, real estate prices are still falling, but prices in Tokyo have risen significantly and this is beginning to spread to other large cities as well. We expect this trend to continue and to become more widespread, and CMBS provide a way to potentially benefit from that trend in our clients' portfolios.

Q: Given PIMCO's expectations for higher inflation, do inflation-linked bonds offer value?

Masanao: Over the secular timeframe, we believe inflation-linked bonds in Japan are attractive versus nominal bonds. Linkers are pricing in a breakeven inflation rate of about 0.6% at the moment, which we find very attractive on a secular basis. Although we are not expecting inflation to rise substantially, still think the current breakeven priced into linkers is low and the downside of owning linkers versus nominal bonds is limited at that breakeven rate.

Other factors also support the case for JGB linkers. One is the expected consumption tax hike. The consumption tax currently is 5%, which is substantially lower than in other developed countries. Thus, the consumption tax needs to rise and we think it is going

Q&A

July 2007

to be higher in our secular horizon. Given Japan's fiscal position, the consumption tax is one of the sources that need to contribute to restoring the fiscal situation, and we think political discussion of the consumption tax will heat up after the July election. The last hike took the consumption tax from 3% to 5%; so we assume there will be another 2% hike this time. We estimate about 80% of that tax hike will flow into the consumer price index that underlies JGB linkers. Based on those assumptions, a 2% increase in the consumption tax translates into a 160 basis point contribution from the CPI to 10-year JGB linkers, or 16 basis points per year. In other words, the current breakeven rate of 60 basis points in inflation-linked JGBs is even lower than it would appear if you factor in the likely increase in the consumption tax—about 44 basis points per year if you exclude the consumption tax increase.

Another important factor that favors the JGB linker market is that Japan's core CPI, which underlies linkers, includes energy prices. Most other major inflation-linked markets, such as the U.S. TIPS market, exclude energy prices from the inflation accruals to inflation-linked bonds. PIMCO's secular forecast suggests higher commodity prices, which should also include higher oil prices. Thus, our secular forecast of higher oil prices should be supportive for Japan's core CPI, which is influenced by energy. In other words, favoring long-term linkers versus nominal bonds is a strategy that can benefit from higher energy prices.

Q: What is PIMCO's view of the Japanese yen and other currencies over the secular timeframe?

Masanao: Our global secular forecast suggests a bearish view on the U.S. dollar given that global aggregate demand is becoming less U.S.-centric and more driven by emerging market economies. So we favor emerging market currencies over the U.S. dollar and also over the Japanese yen. Owning higher-yielding emerging market currencies versus the yen provides attractive carry since the yen has the lowest short-term interest rate among developed markets. Demographic trends that speak to investor demand for higher returns also should benefit non-yen assets and currencies.

That said, over the short-term cyclical horizon, we expect to maintain a modest position in the yen versus the U.S. dollar as a hedge against an increase in risk aversion. Although our secular base case scenario is a global Goldilocks environment, we remain concerned on a cyclical basis about the U.S. housing market leading to a slowdown in the global economy. If the U.S. housing market recession were to spill over into the broader U.S. economy and then the global economy, investors could become more risk averse over the short term. Since many investors are already short the Japanese yen versus higher yielding currencies, we believe long yen exposures versus the dollar offer an attractive play on the potential for risk aversion. However, our secular themes do not suggest long yen as a major long-term bet.

Q: Outside of Japan, where does PIMCO see the greatest potential to profit from continued global growth?

Masanao: One way we can participate in a global Goldilocks environment as a bond manager is to own high quality emerging market currencies. Some of the most attractive emerging market currencies are those of Russia, China and other Asian

Q&A

July 2007

countries, and Brazil. We also see attractive opportunities in emerging market local debt, particularly in Brazil and Mexico.

Q: Thank you. We look forward to speaking with you again about PIMCO's outlook for Japan following the firm's next Cyclical Forum in September.

Past performance is no guarantee of future results. This article contains the current opinions of the author but not necessarily those of Pacific Investment Management Company LLC. Such opinions are subject to change without notice. This article has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

Each sector of the bond market entails risk. Inflation-indexed bonds ("Linkers") issued by the various Governments around the world, also known as ILBs, are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation. Repayment upon maturity of the original principal as adjusted for inflation is guaranteed by the Government that issues them. Neither the current market value of inflation-indexed bonds nor the value a portfolio that invests in inflation-indexed bonds is guaranteed, and either or both may fluctuate. Inflation-indexed securities decline in value when real interest rates rise. The difference in yields between the nominal and inflation-indexed bonds is called the breakeven inflation rate. Mortgage-backed securities are subject prepayment risk and may be sensitive to changes in prevailing interest rates, when they rise the value generally declines. Investing in securities denominated in currencies other than your own may entail risk due to economic and political developments, which may be enhanced when investing in emerging markets. Currency rates in non-U.S. countries may fluctuate significantly over short periods of time and may reduce the returns of a portfolio.

Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, as an offer or solicitation, nor as the purchase or sale of any financial instrument.

No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC, 840 Newport Center Drive, Newport Beach, CA 92660. ©2007, PIMCO.