

Cyclical Forum

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Scott Mather Discusses PIMCO's European Cyclical Outlook and Strategy



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Mr. Mather is a Managing Director, member of PIMCO's Investment Committee and head of portfolio management Europe. He also manages euro and pan-European portfolios. In addition, he works closely with many Allianz related companies and is a Managing Director of Allianz Global Investors KAG in Germany. Previously, he co-headed PIMCO's mortgage and ABS team and managed portfolios of European Supranationals and U.S. agencies. Mr. Mather joined the firm in 1998, previously having been associated with Goldman Sachs in New York, where he was a fixed income trader specializing in a broad range of mortgage backed securities. He has thirteen years of investment experience and holds both a bachelor's and master's degree in engineering from the University of Pennsylvania, as well as a bachelor's degree in finance from The Wharton School of the University of Pennsylvania.

Managing Director Scott Mather is the head of PIMCO's portfolio management in Europe and a member of PIMCO's Investment Committee. PIMCO's investment professionals recently met for the Cyclical Forum in Newport Beach to discuss the six to 12 month economic outlook. In the interview below, Mr. Mather highlights PIMCO's conclusions and explains how these views are influencing the firm's European outlook and investment strategy.

Q: PIMCO recently held its Cyclical Forum to discuss the economic outlook for the coming six to 12 months. Could you briefly describe PIMCO's views from the March Forum that formed the starting point for the recent discussion?

Mather: During the March Forum we focused on the unfolding U.S. slowdown and discussed the uncertainty with respect to its impact on Europe. We saw the signs of continued decoupling between Europe and the U.S. but the question was how long this could continue. An important factor in our considerations were the impacts of fast growing economies in Eastern Europe, the Middle East and Asia on Europe. The euro zone and the U.K. had benefited tremendously from this growth which more than compensated for the weakness stemming from the developed world trade partners like the U.S.

One big question for discussion was, whether the European consumer would kick in and add more meaningfully to growth. Consumption had been relatively weak throughout this economic cycle, leaving Europe with business production and investment as the primary drivers of growth throughout much of the cyclical upturn. Although we anticipated a smaller than usual drag on the business sector from a U.S.-led slowdown in the developed world, the impact of this would need to be offset by some renewed vigour in the consumer sector if Europe was to emerge unscathed.

We also expected some negative impacts on the European economy from the lagged effects of monetary tightening and from the strong euro as well as the British pound. Rates had already been raised substantially and the markets priced in even more policy tightening action by the European Central Bank (ECB) and the Monetary Policy Committee (MPC).

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Q: How has the situation changed since the March Forum and how have these changes influenced the discussions at the recent Forum?

Mather: The biggest change in the economic environment was spawned by the market turmoil that ensued after problems in the U.S. subprime mortgage market spilled over into a global markets and lead to a full blown liquidity crisis and credit crunch. The Forum discussions focused on how important this credit crunch would be for the markets, the extent to which this would accelerate a slowdown of the U.S. economy, and how contagion would further influence the outlook for Europe.

We focused on the transmission mechanisms of a U.S. slowdown on Europe through both traditional economic and trade linkages as well as financial and business confidence channels. Trade linkages with the U.S. in particular have become less and less important over time as the rest of the world has offered a much faster rate of growth for European exports than in prior cycles. In isolation, the diminished importance of the U.S. as a growth engine for European exports suggested a larger degree of decoupling for the European economy.

However, the crisis in the credit markets has changed the landscape dramatically and showed us how important the links between financial markets really are. The speed and severity with which the financial crisis spread clearly represent a major risk for European growth. Moreover, the U.S. remains the major source of global consumer demand growth. If U.S. consumer spending was to slow sharply, this would be a stern test for European growth and for the world economy.

Q: Can you elaborate on the impact financial linkages have on economic growth in Europe?

Mather: The liquidity crisis has tightened credit conditions dramatically in Europe. Both the price and availability of credit have changed substantially. Businesses and consumers will find all forms of credit increasingly more expensive and difficult to obtain.

The repricing of risk was readily apparent in the credit sectors of the global bond markets where spread of both high and low quality ABS, corporate and mortgage bonds widened by historic proportions. While emerging market spreads have also widened, it is notable, though, that during a period of stress in developed country financial markets, emerging economies and markets have provided a relative source of stability.

Less obvious, but perhaps of more importance was the dislocation caused in the interbank money market, the market for high quality short term borrowing between international banks. Here, the price for credit rose sharply higher despite the ECB and MPC moving to a neutral bias. The economic effects of this take some time to work through the system but it is important to realize how significant this development will likely prove to be. Banks will pass on the higher cost of funds to both consumer and businesses alike. In effect, the higher price of interbank lending is acting on the economy in the same way as if the ECB and MPC had continued to hike rates by additional 50 to 100 basis points beyond the hikes that have already occurred in the policy rate over the last year.

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And it is not just the pricing of credit that has changed. The availability of credit has changed considerably in light of the uncertainty about the financial markets, liquidity, and the economy. Lending standards are being reviewed and tightened substantially across many borrower segments. In the U.S., and also in the U.K., the tightening of mortgage lending standards are particular threats to the outlook.

The higher price and reduced availability of credit has already begun to hurt business confidence. This will have a knock-on effect on investment spending – the real driver for much of the recent expansion in Europe. The credit crunch will therefore soon be felt in weaker economic data since investment spending is very sensitive to changes in the economic sentiment.

Q: If investment spending is impacted by the credit crunch, will consumers be able to sustain growth in the European economies?

Mather: That is a very important question. We are not convinced that the European consumer is about to return to spending at robust levels seen in previous expansions. The data show relatively weak consumption numbers when adjusted for this phase of the economic cycle, especially in the euro zone.

Some of this weakness can be understood by considering the ingredients necessary for consumer growth. The consumer needs both the capacity and the will to spend. At least one of the two ingredients has been lacking for U.K. and Euroland consumers during this cycle. In the euro zone, employment growth has been robust and savings rates are starting from a relatively high level. However, these strengths have been offset by very weak growth in real wages and a cautious consumer. Consumers have also had to bear the “tax” of higher energy prices.

The double-edged sword of globalization has thus far acted to boost European growth through exports and business investment channels but with the consequence that real wages have experienced very weak growth and limited the consumer participation in the growth recovery.

The tightening of credit conditions, both in terms of cost and credit availability, are therefore quite certain to dampen consumer spending going forward. In addition, there are signs that major European housing markets peaked one to two years ago in terms of price gains and activity. This housing slowdown is likely to further limit consumer will and capacity to increase spending. In short, it seems unlikely that consumers will pick up the slack that may develop from even a mild drop off in business spending.

Q: What impact does a slowdown in the housing market have on consumption?

Mather: In contrast with the euro zone, it is not the British consumers will to spend, but rather the capacity for additional spending that represents the weakest link to a more robust consumer dynamic. While real wage growth in the U.K. has been comparatively stronger than the euro zone, savings rates are already quite low and debt burdens are high. In addition, mortgage equity withdrawal which has featured prominently in the U.K. and acted to support consumer spending is likely to be at risk going forward.

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The U.K. is one of the most exposed of the European countries to a housing slowdown. Affordability of housing is extremely low, debt burdens are very high and mortgage rates are on the rise as [Myles Bradshaw pointed out in his European Perspectives](#). The effects from the Bank of England's previous official rate hikes have yet to be fully felt as many 2- and 5-year fixed rate mortgages are only now reaching a rate reset date. Add to this the increase in borrowing rates from the money market dislocation combined with the more limited availability of credit arising from the credit crunch and you have the risk of a serious retrenchment in consumer spending.

There are some similarities between the U.K. and the U.S. in the way house prices impact economic growth that are worthy of considerations. As in the U.S., U.K. consumers have run their actual savings rates down close to zero, presumably under the assumption that the house price increases negated the need to save out of current income. Like in the U.S., home equity withdrawal has been an additional driver of consumption and amounted to 7% of disposable income at its peak. With slowing house price appreciation, consumers won't be able to extract as much equity going forward – certainly not at the same price and not as easily. This will impact consumption in the future.

However, there are also differences that make the outlook for the U.K. housing market not as dire as it is for the U.S. The U.K., for example, does not have the problem of supply overhang as the U.S. does from years of overbuilding. In addition, housing related activity has not been as important to direct economic activity as it has been in the USA.

Q: How vulnerable is the Euroland housing market?

Mather: The countries most exposed to a housing slowdown in the euro zone are Spain, Ireland and France. Spain witnessed a substantial real price appreciation in housing and a huge amount of construction, creating oversupply. As in the U.S., the diminished outlook for construction spending in Spain will result in a direct drag to GDP growth as construction activity falters while inventory is worked off. Additional knock-on effects to consumption are a risk further down the road. In France, Ireland and much of the rest of the euro zone, house price appreciation looks to have peaked as long ago as 2005. While affordability in Euroland is not as far stretched as in the U.K., slower house price growth will still dim the outlook on consumption going forward as [Matthieu Louanges shows in his European Perspectives](#).

Q: With little hope for help from the consumer, what is PIMCO's growth and inflation forecast for Euroland and the U.K.?

Mather: We didn't make dramatic changes in our inflation outlook from our previous meeting but we have revised growth estimates down a little bit. We expect euro zone growth of 2% to 2.5%, down from our March forecast of 2.25% to 2.75%, and our core inflation forecast is unchanged at 1.75% to 2.25%. This forecast really reflects our view that consumption won't change from current levels but that investment spending is likely to be less robust than in past years. For the U.K. we see growth at 2% to 2.5% and core inflation at 1.75% to 2.25%. The downside risks in the U.K. from the liquidity crisis and a possible housing slowdown are quite significant, though.

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Q: The liquidity crisis triggered action from the ECB and MPC. Do they have the situation under control now?

Mather: Both ECB and MPC were, in retrospect, a little slow to react to the unfolding crisis. After reconfirming a tightening bias in early August, the ECB quickly reversed course by indicating a neutral posture in the face of growing risks to the economic outlook. The ECB followed up by introducing special money market operations designed to normalize functioning of the interbank market. While these operations have helped stabilize the interbank market and prevented further deterioration in conditions, they have not yet returned the market to normal pricing and functioning.

The BOE took a very different approach in taking a hands-off hard line right up until the Northern Rock bank crisis. This led to an even greater liquidity crisis in the U.K. banking system and tightened financial conditions severely. The crisis culminated in the collapse and de facto nationalization of Northern Rock, a major mortgage lending bank. The MPC then softened its stance and instated other special money market normalization operations, although not to the degree of the ECB.

While both the ECB and MPC undoubtedly welcomed some initial tightening in financial conditions, the situation clearly worsened at a much faster rate than they anticipated. Their actions have thus far succeeded in stabilizing a state of affairs that was spinning further out of control by the day. But the current situation is still far from normal and further deterioration in market conditions requiring much more dramatic actions on the part of both the ECB and MPC cannot be ruled out.

Q: What next steps do you expect from the ECB and MPC?

Mather: We think the MPC will embark on a rate cutting cycle soon. The ECB will remain on hold for an extended period but there is a greater likelihood that the next move is a cut rather than a hike. Prior to the recent credit crunch, it was clear that both the ECB and Bank of England (BOE) had the desire to raise rates further. Both have now signaled a more neutral bias but it is our expectation that the MPC will be reducing rates relatively soon.

In the U.K., we think the 5.75% base rate was already quite restrictive before the credit crunch set in during the summer. Since the last rate hike, financial conditions have become much more restrictive as the price of credit has risen substantially and the availability has been restricted to both business and consumer alike. In addition, inflation has fallen below the BOE target of 2%. This should help alleviate inflation concerns at the MPC and paves the way for more immediate cuts in the policy rate to help offset the tighter financial conditions. In addition, if housing market weakness exacerbates the economic decline, we expect policy rates will need to be cut well beyond neutral and into the accommodative zone.

The situation is a bit different in the euro zone. The fundamentals are stronger. The ECB policy rate of 4% is not far from neutral but the ECB remains worried about upside risks to price stability from tight capacity constraints. Prior to the credit crunch, one of the ECB's chief concerns was rapid money and credit growth. It is still too early to see how the credit crunch will impact these numbers but we must pencil in a much more benign outlook going forward. Just like in the U.K., the tightening in financial conditions has been

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dramatic and is undoubtedly acting to slow the economy in the same way that a series of three or more 25 basis point rate increases would have done.

As in the U.K., inflation is close to target. However, the euro zone consumer is unlikely to be as dramatically impacted from the credit crunch as the consumer in the U.K. The monetary transmission mechanism to the consumer is weaker in the euro zone than the U.K. In addition, the consumer is in relatively better shape in Euroland and the housing market is not as big of a risk factor. The ECB is likely to be much more reluctant to cut rates than the MPC and is firmly positioned in a data dependent mode. The ECB will likely be content to watch the euro zone economy slow to a growth rate of 2% or less in order to alleviate tight capacity constraints. The future course of the ECB policy rate will therefore depend critically on the evolution of world growth and the interplay of both trade and financial transmission channels.

Q: How are these conclusions shaping PIMCO's investment strategy over the coming six to 12 months?

Mather: We expect that official interest rates in the U.K. will need to be lowered relatively soon to help offset the credit crunch and return rates closer to neutral. We believe shorter maturity U.K. bonds should therefore outperform most other sectors going forward. In addition, the curve is likely to steepen and adopt a more normal upward sloping position as rates decline, led by the short end. Portfolios are positioned to potentially benefit from these developments with longer than average durations and yield curve steepeners.

We also seek to take advantage of further rate cuts in the U.S. The easing cycle in the U.S. is still in its early stages and both short and intermediate rates will need to decline significantly from current levels to provide stimulus for an economy burdened with an unprecedented mortgage and housing crisis coupled with a dangerously overleveraged consumer.

Q: What are PIMCO's views on currencies?

Mather: Our strongest view in the currency arena is on the U.S. dollar which we anticipate will weaken further. Although the dollar has depreciated substantially already, the relative underperformance of the U.S. economy coupled with the beginning of a rate cut cycle is likely to further pressure the dollar. International savings, both official and private, are still too dollar heavy in terms of asset mix, and the steady diversification into other currencies will also act to push the dollar lower. Emerging market currencies should be primary beneficiaries against the U.S. dollar, although strength in other developed market currencies such as the Australian and Canadian dollar and the euro should be expected. The British pound is entering a more vulnerable period given our outlook, but we still expect it to fair better than the U.S. dollar.

Q: PIMCO has long been underweight credit. Has the firm's view changed given the recent turmoil in credit markets?

Mather: Credit risk has undergone a dramatic re-pricing in Europe. Both the primary and secondary market hold many more opportunities for us now than they have in the past. We have been adding credit selectively to our portfolios but remain relatively cautious as we think there will be ample opportunity to add credit going forward and we anticipate more bouts of market turbulence. Although credit risk premiums have widened

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considerably along the entire credit quality spectrum, we still favour high quality spreads over lower quality at this point in the economic cycle. Caution is especially warranted for credits exposed to further weakening of U.S. demand and credits that are overly reliant on continued cheap and plentiful credit from the capital markets.

Q: Do you see value in other sectors as a result of the liquidity crisis?

Mather: The most recent market dislocation has created many opportunities to capture abnormally high liquidity and credit risk premiums that are appearing in the highest quality assets, especially in European and U.S. asset-backed and mortgage-backed securities. Some normalization of risk and liquidity premiums in high quality spread products should be anticipated as the central bank actions and passage of time begin to normalize markets.

Q: Thank you, Scott.

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Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

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