

Cyclical Forum

December 2007

Paul McCulley Discusses PIMCO's Cyclical Outlook and Investment Strategy



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Mr. McCulley is a Managing Director, generalist portfolio manager, member of the investment committee and head of PIMCO's Short-Term Desk. He also leads PIMCO's Cyclical Economic Forum and is author of the monthly research publication *Global Central Bank Focus*. Mr. McCulley joined PIMCO in 1999, previously serving as Chief Economist for the Americas for UBS Warburg. During 1996-98, he was named to six seats on the Institutional Investor All-America Fixed Income Research team. He has twenty-two years of investment experience and holds a bachelor's degree from Grinnell College and an MBA from Columbia University Graduate School of Business. McCulley co-authored the book *Your Financial Edge*, released in June 2007.

PIMCO Managing Director Paul McCulley leads the firm's quarterly Cyclical Economic Forums, in which our investment professionals from around the world gather to discuss the outlook for the global economy and financial markets over the next 12 months. In the following interview, Mr. McCulley discusses the results of the December Forum and its implications for PIMCO's investment strategy.

Q: PIMCO held its latest Cyclical Economic Forum in December. How did the discussion progress, and what were the key themes?

McCulley: We changed things up a bit this time around. Usually, we start by going around the world and discussing the real side of the global economy before considering aggregate level financial matters, on the simple proposition that real side fundamentals are the dogs that wag financial variable tails. But right now, the dogs have become fascinated with chasing their tails because we are in the middle of a turning point from a period of ever-increasing risk appetite to a period of ever-increasing risk aversion.

As I've often mentioned, this movement from risk seeking to risk aversion is a Reverse Minsky Journey. This is a reference to the late great economist Hyman Minsky, who famously taught us that stability is ultimately destabilizing. The bottom line is in Minsky's theory, economic cycles can be described by a progression – in forward or reverse – through three income-debt relations for economic units: "hedge" financing units, in which the buyer's cash flows cover interest and principal payments; "speculative" finance units, in which cash flows cover only interest payments; and "Ponzi" units, in which cash flows cover neither and depend on rising asset prices to keep the buyer afloat. (For more on Minsky, see Paul's *Global Central Bank Focus* columns from [March 2007](#), [October 2007](#), and [December 2007](#)). In the Reverse Minsky Journey, we are moving through this progression backward, with asset prices falling, risk premiums moving higher, leverage getting scaled back and economic growth getting squeezed.

Thus, it made sense, I thought, to start our discussion right up front with an assessment of where we are on the Reverse Minsky Journey: how far have we traveled, how much further do we have to travel, and what will stop it? And most important, perhaps, can and will it be stopped without a United States recession, keeping intact on a short-term

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cyclical basis our “soft” global de-coupling thesis? Our long-term secular thesis is, as you recall, for a “hard” global de-coupling story.

Q: How much further does this Reverse Minsky Journey have to go?

McCulley: As we discussed at our Forum back in September, well before consensus fully grasped what was going on, the key force in the Reverse Minsky Journey is shrinking and deleveraging the “Shadow Banking System” – the whole alphabet soup of non-bank conduits, vehicles, structures, et al – which had been the marginal price setter of ever-skinny and overly leveraged risk premiums in recent years. It all went swimmingly, dampening volatility in a self-reinforcing way, until the bubble in the property and mortgage markets created by financial alchemy hit the fundamental wall of housing affordability. Ultimately, fundamentals do matter!

Or, as the great Warren Buffet says, we only know who’s swimming naked when the tide goes out as it inevitably does. And it ain’t a pretty sight, as Minsky’s “Ponzi” debt units – which are viable only so long as the levered asset appreciates in price – are revealed. Such is presently the case in the U.S. housing market, with nationwide deflation taking out the “Ponzi” units and transforming Minsky’s “speculative” units – which are viable only so long as the levered asset doesn’t deflate in price – into after-the-fact “Ponzi” units. Again, it ain’t pretty.

The critical issue now is figuring out how far the Reverse Minsky Journey has to run. And this is really a two-part exercise, as Mohamed El-Erian sagely noted, which involves both actions and reactions. We the markets are way ahead of Main Street and policy makers in understanding the nefarious nature of the unwinding of double bubbles in the U.S. property and mortgage markets and the global Shadow Banking System. It’s going to be a long, nasty unwind, which the markets are in the process of discounting. Notably, the mortgage markets are pricing in huge numbers of defaults that have yet to happen, and aggressive Federal Reserve easing that has yet to happen.

Such is the nature of capital market-centric financial systems, where mark-to-market and margin calls are the coin of the realm, in contrast to bank-centric financial systems, where reserving against book value for future credit losses is standard procedure. As a thesis, this implies that countries with capital market-driven financial systems will take the asset price pain of a Reverse Minsky Journey far quicker than countries with bank-driven financial systems. As a corollary of that thesis, the turning point in investment strategy for increased risk taking may come much quicker in capital market-centric countries than bank-centric countries – especially those that are burdened by balance sheet overhangs.

Q: What were the key forecasts and outcomes that came from the Cyclical Forum?

McCulley: Our global base line forecast remains a soft landing, with some degree of global decoupling of growth from the U.S., and generally stable inflation. But we are not nearly as confident in this projection as we were three months ago, as we are getting a very clear demonstration of the importance financial market linkages between the U.S. and other global economies. Yes, each country around the world has its own Main

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Street business cycle, with its own internal rhythm. But global capital markets are increasingly coupled, not de-coupled. Financial innovation on levered steroids has been America's great export and the world has been a big buyer.

Thus, we've edged down both our U.S. growth forecast and our expectations for the rest of the world as the capital market linkages become increasingly apparent. Inflation, meanwhile, is expected to stay in the upper ranges of central banks' comfort zones in most regions, with buoyancy in commodity prices and the beginning of a turnaround in the disinflationary impact of emerging markets. So bottom line, we are still looking for a global soft landing, just a touch less soft and with a touch more stagflationary smell.

In the U.S., we're forecasting GDP growth in a range from 0.75% to 1.25%, down a half a percentage point from our September forecast. We're also looking for consumer inflation, measured by core personal consumption expenditures, in a range from 1.75% to 2.25%, up a bit from our September forecast.

In Euroland, we're expecting growth to range from 1.75% to 2.25%, down a quarter point from our September forecast. Core Euroland CPI inflation is expected to sit in a range between 2% and 2.5%, up a quarter point from the September forecast.

For Japan, we expect GDP growth between 1% and 1.5%, down a quarter point from September, and core CPI between -0.5% and 0%, unchanged from September.

In the U.K., our forecast is for growth between 1.5% and 2%, down a half point from the September, and core CPI of 1.75% to 2.25%, unchanged from September.

These are our base case forecasts, but as usual, what's interesting and wager-able from a portfolio perspective is the distribution of risks around each of these base cases. For this, we'll have to go around the world.

	U.S.	Euro Zone	U.K.	Japan
GDP	0.75% - 1.25%	1.75% - 2.25%	1.50% - 2.00%	1.00% - 1.50%
Inflation	1.75% - 2.25%	2.00% - 2.50%	1.75% - 2.25%	-0.50% - 0.00%

* PCE for U.S., CPI for Euro Zone, U.K. and Japan

Q: Let's start with the U.S., where housing, mortgages and consumer spending have been key cyclical themes for PIMCO for some time. Did this outlook change at all at the December Cyclical Forum?

McCulley: On Main Street, not all that much water has passed under the bridge since our September Forum. We knew then that the housing market was in a nasty recession, fully expecting it would get nastier still for an extended period. We've long believed that housing market volumes would collapse before prices, and so it has come to pass, with home price deflation picking up in recent months. So not much new news there.

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But on Wall Street, there has been much water, also known as red ink, under the bridge since September, with both the traditional banking system and its shadow sibling facing reality, if not fully embracing it. Financial conditions, notably terms, conditions and pricing for anything but conventional mortgages have tightened dramatically, to the point of ignominious death for “affordability” product. Conventional bank balance sheets have continued growing, not voluntarily, but out of prior contingent liabilities that have been triggered. What is more, tightening lending standards are spreading beyond the residential mortgage sector, including the commercial sector, as Josh Anderson detailed during the Forum.

These outcomes have, of course, induced the Fed to ease monetary policy, and there is more to come. The risk has also grown considerably that housing’s woes will spill over to consumer spending. To be sure, spending has held up remarkably well so far. But that does not mean, we collectively agreed, that it inevitably will continue to do so. Americans may always have the will to spend, but actual spending requires both will and wallet, and the wallet is facing serious pressure with the tap shut on mortgage equity withdrawal and elevated petrol prices, which is a real negative terms of trade shock.

Beyond that, new research presented by the North American Team on property price behavior in the wealthiest six states versus the rest of the country was very instructive: those states have outperformed rather dramatically in recent years but have now rolled over. And while we don’t have rich data on the spending behavior of those six states versus the rest of the country, it is a reasonable thesis that relative spending follows the same pattern as relative home price appreciation. Thus, we remain convinced that it is just not credible to expect consumer spending to continue to “bail out” aggregate economic growth with the same vigor as in recent quarters.

This is particularly the case in the context of prospective weaker employment growth, which historically follows corporate profitability and, for smaller companies, lending conditions. Profits are being squeezed across the board domestically, even if large companies continue to rack them up abroad, and pricing power in the face of rising costs is a rare luxury. Small businesses are finding their bankers hunkered under their desks. Unemployment has only just begun to climb, we collectively believe. Gradually, but persistently, climbing initial unemployment claims are finally – finally! – signaling that we aren’t just singing Dixie on this score.

Bottom line, we are implicitly forecasting that the United States economy will continue to grow at an even lower “stall speed”. Maybe it will, on the back of robust net exports and timely, aggressive monetary and fiscal stimulation. But it ain’t a done deal. The fat tail risk is still recession and the Fed’s mission is still to cut it off. Fed Chairman Bernanke and Vice Chairman Kohn have recently effectively screamed that they “get it.” Neutral is as neutral does and policy ain’t neutral!

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Q: At the last forum, PIMCO was still expecting for some degree of decoupling between slowing U.S. growth and growth in Asia. Is this decoupling as pronounced as you had expected?

McCulley: Japan appeared earlier this year to be grasping growth victory from deflationary defeat. Regrettably, it now appears that the victory, if it can still be called that, is a small one, as growth is sharply decelerating. The primary reason is, to be sure, an administrative tightening in zoning laws for construction, which is pounding that sector. But it would be foolhardy to see this as a mere flesh wound, a one-off that will quickly correct upward.

What is more, hope has sprung eternally that sturdier Japanese consumer spending would join heretofore-strong investment spending. But the handoff from business to consumers isn't happening. Real income growth is anemic in large part because older workers, whose pay was a function of tenure, are leaving the system. The base case must be for continued moribund consumer spending growth. Beyond that, continued robust capital investment is not a done deal, particularly as Japanese lenders, like their counterparts around the world, exercise far more conservative underwriting standards, particularly with small businesses.

The good news, at least from a financial markets perspective, is that the economic outlook puts the Bank of Japan on perma-hold on interest rates. To be sure, the Bank of Japan will likely continue to talk a game of continued upward normalization of policy rates, once global growth uncertainty subsides and financial stresses moderate. But it will just be talk. The bottom line is that Japan needs very low short rates for a very long time.

With respect to China, the news continues to be robust, with increasingly positive signs of shifting of investment toward domestic infrastructure and away from export-oriented sectors. But difficulties associated with maintaining the undervalued yuan grow by the day, notably through domestic asset price bubbles in the face of increasing difficulty in sterilizing capital inflows, and through global protectionist pressures. While a steady crawl upward for the Chinese currency remains the base case, the risk case of something more big bang-ish is likely to grow over our cyclical horizon.

Q: Europe had also been seen as partly resilient to a U.S. slowdown, but we've seen European growth itself slowing. Is this the result of the financial market linkages you mentioned earlier?

McCulley: Europe's economy felt like it was booming six months ago, though we reminded ourselves that it really is a low beta region when it comes to growth. For Europe, robust growth is at the top of the 1.5% to 2.5% zone, and gnashing of teeth is at the bottom of the zone. We at PIMCO can pat ourselves on the collective back for that insight. The growth glow has dimmed, period. And while there are many reasons, top of the list is that financial market turmoil in Euroland is every bit as bad as in the U.S., if not worse, because Euroland shadow bankers lost their fiduciary ball in even deeper rough than their American brethren.

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In turn, small companies – cash short and dependent upon banks in a bank-centric financial system – are likely to be in retrenchment mode relative to recent years, impacting both investment and job creation. Meanwhile, the property bubble in southern Euroland – notably, Spain – is busting, not unlike the U.S. Thus, the Europe-U.S. de-coupling story, while still viable, is turning a whiter shade of pale, dependent primarily on Euroland exporting to emerging markets. Such a contribution to growth is a very viable proposition, given the ruddy health of the emerging markets, particularly the oil exporters. But is that single reed of demand strong enough to support an optimistic scenario for the entirety of Euroland? We think not.

We should also mention the U.K. here, because the outlook there has dimmed considerably. Not unlike the United States, a key reason is that the bubbly housing market is losing its fizz on the back of sharply tighter terms, conditions and pricing for mortgage credit, particularly for the buy-to-let market, which has been the marginal driver of property prices in recent years.

What's more, U.K. monetary policy ain't easy or accommodative, even after the quarter-point rate cut from the Bank of England on December 6. In fact, we believe that policy is effectively tighter because term funding rates have soared relative to the BoE policy rate. Thus, the downside risk in the U.K. looks awfully similar to that of the U.S., with the only silver lining being that the U.K. doesn't have a huge overhang of unsold newly constructed homes.

Even after its December 6 rate cut, the BoE indicated that it is still worried about inflation, which could damp the prospect for further cuts in the near term. Accordingly, it is hard to avoid the conclusion that the BoE wants to dole out stealthy punishment to the Shadow Banking System that has thwarted its tightening policies for years. There is a limit to this Calvinist proclivity, however, we collectively agreed, where the Bank of England will have to ease further, despite an adversity to moral hazard.

Q: So Japan and Europe and the U.K. seem a bit more cyclically “coupled” with the U.S. growth story than you previously thought, but what about emerging markets?

McCulley: For emerging markets, the story is much as it's been for a long time: improving domestic fundamentals and institutions, large stocks of self insurance in the form of reserves, and the joy of riding a positive terms of trade shock borne of soaring commodity prices. But as the EM team detailed yet again, the EM block is still not running on homegrown Keynesian domestic-demand fuel.

To be sure, many developing economies are moving in the direction of becoming more focused on domestic demand. Most importantly, increasing stores of sovereign wealth are being directed at building, re-building and improving domestic infrastructure. This is particularly the case in China, Russia and the Middle East. But these are incremental moves, not powerful Keynesian countercyclical moves. Collectively, these countries could do more, quickly. But for now, EM still seems to be haunted by post-1998 orthodoxy. In the past, the EM countries tended to “go Keynesian” when they were not in a position to sustain the move. Today, they have chosen so far not to go Keynesian

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even though they can. So while we don't expect EM growth to be derailed by slower growth in the developed world, we also don't expect it to be supercharged by a shift toward domestic demand-driven growth.

Q: What are the investment implications of PIMCO's cyclical outlook?

McCulley: As we contemplate and forecast global markets, we must accept a degree of cognitive dissonance. Things that should be uncorrelated on the basis of real-economy fundamentals become correlated at a Minsky Moment. The early risk-seeking bird does not necessarily get the cheap worm, as it becomes cheaper still, despite putative compelling fundamental value. Reversal points in either Forward or Reverse Minsky Journeys are not about fundamentals per se, even though they have fundamental origins, but rather policy: when, where and how do policymakers say enough is enough?

In U.S. financial markets, and therefore global financial markets, restraint is never enough when bubbles are forming. Relief is always late, even if eventually sufficient, because policymakers fear being charged with moral hazard, or of bailing out bad decision makers. Whether this paradigm is normatively right or wrong is not our issue, regardless of how we may personally feel about it. It simply is.

We are paid to play the game, notably by anticipating changes in the rules and conventions of the game. This Forum, unlike most, started with that premise.

For further details on PIMCO's post-Forum investment strategy, please see the upcoming Q&A with Bill Powers on www.pimco.com.

Q: Thank you, Paul. We look forward to speaking with you again following PIMCO's March Cyclical Forum.

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