Cyclical Forum

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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 March Forum and its implications for PIMCO's investment strategy.

Q: PIMCO held its latest Cyclical Economic Forum in March. Did the discussion take the same unusual format as at the December forum, leading with an assessment of financial conditions rather than global economic conditions?

McCulley: Yes. I thought it continued to make sense to start our discussion right up front with an assessment of where we are on the Reverse Minsky Journey. That is, how far have we traveled down the road of deleveraging, how much further do we have to travel, and what will bring us to the end?

The other key areas we examined were the state of, and outlook for, the U.S. economy and the global repercussions of the U.S. slowdown. That is, presuming we are in the moral equivalent of a recession in the United States, how deep and how long will it be? And, critically, will the cyclical "soft" global de-coupling thesis hold up, reducing the impact of a U.S. recession on other regions?

But as we are at a Minsky Moment – the turning point from a Forward Minsky Journey of ever-increasing risk appetite and leveraging to a Reverse Minsky Journey of ever-increasing risk aversion and deleveraging – the dogs have become infatuated with chasing their tails, and so we started with the tail that may be wagging the dog.

Q: The Minsky Journey has been a focus of the last two cyclical forums. Why is this so applicable to the excesses we saw in financial markets and the painful unwinding of that risk taking that continues today?

McCulley: The late great economist Hyman Minsky 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). The progression of risk taking in the financial markets to the Ponzi units represented by the excess of subprime loans and SIVs (structured investment vehicles) was the Forward Minsky Journey. 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.

Minsky's "Ponzi" debt units are only viable as long as the levered asset appreciates in prices. But when the price of the asset declines, as is presently the case in the U.S. housing market, it becomes clear that the emperor has no clothes. Minsky tells us we must now go through the process of increasing risk taking in reverse, which is what we are seeing with all its consequences.

Q: What is the progression of this reverse journey of de-leveraging and re-pricing of risk?
McCulley: Basically we're talking about a giant margin call.

What we have been witnessing over the last year is a bursting of triple bubbles: in property valuation in the U.S., in mortgage creation, again, principally in the U.S., and in the shadow banking system, not just in the U.S. but around the world. The blowing up of these three bubbles demands a systemic re-pricing of all risk, which is deflationary for all risk asset prices.

Deflation in risk assets is also deflationary for levered lenders, directly, due to asset valuation markdowns and, indirectly, due to rising risk asset price volatility. Financial institutions are forced to de-lever their balance sheets to accommodate higher volatility in the prices of their risk assets because of the straightjacket of value-at-risk (VAR) risk management models. Obviously, these restrictions on lenders' balance sheets likewise restrict the availability of credit.

This process of debt deflation, as we have said time and time again, is not self-correcting, but rather self-feeding. Further federal stimulus, both monetary and fiscal, will be required to create an environment where there is both the capacity and incentive for these institutions to lend and take some financial risk. And this damage has not, and will not, be contained to the Wall Street-driven financial system, but has and will generate carcinogenic pathologies on Main Street-driven growth in jobs, income, and spending.

The last recession in 2001, which was driven by a bursting stock market bubble, was confined primarily to business investment. But the current slowdown was precipitated by the bursting of the residential property bubble. The property market is in a depression. Approximately 10% of Americans have negative equity in their homes and that could be 20% by the end of the year. Rising home equity bolstered consumer spending in the last recession. Now, consumer spending is squarely in the cross hairs, on the back of falling home prices.

Until property deflation is stopped, nothing else is going to work in our economy.

Q: We have seen the significant Fed easing that you expected at the December Cyclical Forum as well as additional credit facilities and some fiscal stimulus in the form of tax breaks. Will these responses be sufficient to contain this self-feeding process?

McCulley: This is not a problem amenable to a simple solution of easier monetary policy. That does not mean that easier money is not necessary or that the Fed is pushing on a string. Rather, it means that the Fed is chasing the neutral real rate down, as it falls in the face of ever tighter private sector credit availability, terms and spreads.

This is a clear and purposeful deviation from conventional Taylor rules, which presume a constant "neutral" real policy rate, as well as a normally-distributed set of risks. Neither of these theories hold up at the moment, if they ever did (see Global Central Bank Focus February 2008) so the Fed has to both chase the falling neutral policy rate down and also try to catch and pass it. This is the only way the Fed can take out insurance against the fat tail risk of a deflationary recession.

The Fed has recognized and accepted this reality, as illustrated by the 125 basis points of ease to 3.00% in an eight day period in January and the further 75 basis points we saw at the latest Federal Open Market Committee meeting March 18. And it may even do more, possibly cutting to 2%, or perhaps 1 ¾%. But monetary policy ease alone, we overwhelmingly agreed, is not sufficient, even if it is necessary, for the financial markets. For the real economy to successfully endure the Reverse Minsky Journey, fiscal policy is also needed.

And not just fiscal policy of the conventional Keynesian type, as has been properly implemented. In addition to easier money and the additional liquidity the Fed is providing to financial institutions trying to maintain their balance sheets as they reduce leverage, there needs to be some kind of a joint venture between monetary and fiscal policy to put a floor under property prices. It is that simple and that profound. We believe expectations of continuing property price deflation will contaminate risk appetite on both Wall Street and Main Street.

So, in addition to the alternative credit facilities the Fed has recently provided, first to banks and then to broker-dealers, we expect the Fed to more aggressively use its balance sheet. They don't just need to lend against mortgage collateral via enlarged Treasury auction facilities and term repo operations, they need to buy mortgage collateral outright. This is, at the margin, a quasi fiscal policy action, in that any losses the Fed were to take would reduce the seinorage rebates it pays the Federal government on the profits and interest generated by its portfolio. This makes it a politically difficult step for the Fed, but it is a step we think they will take, as the political climate evolves toward recognition that all tools must be employed.

Concurrent with these moves by the Fed, some form of direct fiscal support of the property market is also needed and is very likely to be forthcoming. Many options are on the table, but at the end of the day, they all involve the simple proposition that Uncle Sam must guarantee refinanced underwater mortgages, with large principle write-downs. This would most likely be accomplished through the Federal Housing Authority in concert with Fannie Mae and Freddie Mac. Although political momentum on this type of fiscal action has not yet reached critical mass, it is clearly moving in that direction, and we feel very confident that it will.

The bottom line is that we need all guns blazing to deal with the housing sector depression.

Q: It seems that there is still a way to go on this Reverse Minsky Journey. How did the forum's views on the persistent problems in the U.S. housing market and the global financial system affect PIMCO's cyclical outlook?

McCulley: PIMCO made major revisions to our forecasts. Fundamentally, we are coming from a perspective that is decidedly more focused on stagflation than we had been. Basically we have a recessionary forecast for the U.S., with less decoupling of growth in the rest of the developed world, but still strong growth in emerging market countries. We expect even higher inflation, borne of still-surging energy and food prices. While we don't explicitly forecast emerging markets country growth, our bias was that the de-coupling thesis still has legs for the developing world, with China probably in the position to have the strongest continuing growth story. However, we agreed that we aren't quite as confident about that as we've been in the past.

Importantly, the second part of the decoupling story persists, and the financial markets are, in contrast, more and more linked these days. At present, financial markets are serving as a primary transmission mechanism for contagion, which also dampens growth prospects, particularly in the developed world.

PIMCO's 6-12 Month Forecasts

	U.S.	Euro Zone	U.K.	Japan
GDP	-0.75% – -0.25%	0.25% - 0.75%	0.50% - 1.00%	0.50% - 1.00%
Inflation*	2.00% - 2.50%	2.25% - 2.75%	2.50% - 3.00%	0.25% - 0.75%

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

With the housing crisis going from bad to worse and showing no sign of abating anytime soon, and debt deflation in a downward spiral, we have reduced our U.S. growth forecast to a -0.75% to -0.25 range down from 0.75 to 1.25%. In light of high food and commodity prices we have upped our inflation outlook to a 2.00% to 2.50% range, up from 1.75% to 2.25%.

In Euroland, there are increasingly internal drivers of slower growth, including collapses in local real estate markets, a banking crisis and persistent need for fiscal reforms, and external drivers such as the U.S. slowdown and the global credit contraction. We have also lowered our growth forecast significantly and raised our inflation outlook slightly. We are now looking for Euroland GDP growth in the range of 0.25% to 0.75% versus 1.75% to 2.25% previously and inflation in the range of 2.25% to 2.75% up from 2.00% to 2.50%.

We believe Japan is somewhat more insulated from both the global financial market turmoil and the U.S. slowdown, in light of their financial system's much lower exposure to risky mortgage assets and diversification of their exports to faster growing emerging market countries. However, domestic demand is still weak, and we've revised our Japanese growth forecast down to a 0.50% to 1.00% range from 1.00% to 1.50%. We've upped our inflation forecast slightly to 0.25% to 0.75% from -0.50% to 0.0%.

In the United Kingdom where the housing and mortgage crises have been among the worst in Europe, we have also revised down our growth forecast significantly, to a 0.50% range to 1.00% from 1.50% to 2.00%. In the UK we have also upped our inflation forecast significantly, to the 2.50% to 3.00% range from 1.75% to 2.25%.

So, we're looking at the moral equivalent of a recession in the U.S., slower growth overall in the developed world, and the emerging markets generally providing the global engine of growth.

Q: What are the investment implications of PIMCO's latest cyclical outlook?
McCulley: In many respects, especially in the months ahead and especially in investment strategy, fundamentals will take back seat to the technical aspects of the unfolding Reverse Minsky Journey and policy makers' efforts to slow it down, if not stop it.

The greater and more forceful the policy response beyond the Fed's aggressive moves so far, the more we plan to shift from curve and duration to spread products. If policy makers are unambiguously targeting spread product – if they are writing a put on spread duration – then you want to own spread product. And to the extent that they write a put on spread duration, the terminal value for the fed funds rate will be higher than would otherwise be the case. Every new policy initiative that you see, in addition to Fed rate cuts, pulls up the terminal value of the Fed Funds rate. The more you use the balance sheet to target the basis, the higher will be the terminal point for the fed funds rate.

The strategic implications are very straightforward. We have been betting very heavily and very successfully on the Fed Funds instrument, both with respect to duration and even more importantly with respect to curve, and that will be moderated in favor of spread duration and high grade assets.

High grade assets have been beaten about the head and shoulders, and not because of the underlying credit quality, but because the deleveraging in the system. The shadow banking system didn't so much lever up junk assets but incredibly high grade assets, and now they're being forced to sell them at fire sale prices. These higher quality securities have underperformed in the blowout, and we're happy to move into these "innocent victims" of the shadow banking system.

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

Past performance is not a guarantee or a reliable indicator of future results.

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