

Cyclical Forum

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

Q: PIMCO held its latest Cyclical Economic Forum in September. What were the key issues discussed in updating the firm's cyclical outlook?

McCulley: As with other recent Cyclical Forums, the main themes at the September Forum were the ongoing U.S. housing market deterioration, the global financial impact of the battered U.S. subprime mortgage sector, and the degree to which this will all affect the U.S. and global economies. All of these factors are currently in play, and our debate centered on just how nasty things might get.

One of the main questions raised in our cyclical discussion is related to PIMCO's longer-term Secular Outlook: Can the world remain an oasis of prosperity while the United States sinks deeper and deeper into the post-housing bubble morass? Central to this debate was whether the global economy can generate sufficient internal demand to offset a lack of U.S. demand, thus decoupling from U.S. growth. We believe the global growth decoupling story is alive in the long term, but it is not as solid as it had been earlier this year, and we examined how it might hold up in the coming months.

The other major question at the Forum was how the current credit crisis will play out in financial markets. In this area, we are in somewhat uncharted waters because it is not necessarily the traditional banking system that is bearing the burden thus far. Instead, the crisis has occurred in the "shadow banking system" – the alphabet soup of non-bank conduits, vehicles and structures that have been extending credit far and wide in recent years. We know these assets and liabilities need to shift back into the real banking system, which is backstopped by deposit insurance and access to central banks' discount windows. But the question is, how orderly will this process be? (For more info, see Paul's [August/September Global Central Bank Focus](#).)

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Q: U.S. housing, and its impact on financial markets and the global economy, have been key cyclical themes for PIMCO for some time. How have events since March affected the debate about the role of housing in the economy and markets?

McCulley: The themes were the same, but some of the questions were quite different. In March, the U.S. housing crisis was becoming critical, but subprime mortgage problems were more or less contained to that sector. Before August, data showed the U.S. economy was doing pretty well aside from the housing recession. Since the rest of the U.S. economy, including the U.S. consumer, had decoupled from the housing sector problems, it was not a big surprise that global growth was also holding up well. But there has been much water under the bridge since our last Cyclical Forum in March! A key part of our March outlook was that the subprime crisis would spread, in contrast to the markets' consensus view that it would remain contained. Today, the spread of subprime contagion is a reality. The debate is no longer "if" subprime will infect the rest of the economy, but how infectious it will be in the U.S. and globally.

Q: Considering the threat of contagion from the subprime sector, what did PIMCO conclude about the outlook for global growth?

McCulley: Though we clearly see some big risks in the fallout of the subprime crisis, our global baseline 12-month forecast remains for a soft landing, with some degree of decoupling of growth across the regions and generalized, modest disinflation.

Given what we've seen so far, we've trimmed our growth forecasts around the world. Turning to the numbers, for the U.S. we expect to see GDP in a range of 1.25% to 1.75%, down from our March forecast for 2% to 2.5%. U.S. core CPI is expected in the 1.5% to 2% range, down from 1.75% to 2.25% in the previous forecast. In Euroland, we see growth of 2% to 2.5%, down from the March forecast of 2.25% to 2.75%, and core inflation expectations are unchanged at 1.75% to 2.25%. For Japan, our GDP forecast declined to a 1.25% to 1.75% range, down from the previous 1.75% to 2.25% range, and the Japan core inflation forecast range was unchanged at -0.5% to 0%. For the first time, we developed a consensus cyclical forecast for U.K. growth at 2% to 2.5%, and for U.K. core inflation at 1.75% to 2.25%.

Our confidence in this baseline forecast is not nearly as stout as it was six months ago – particularly regarding global growth decoupling from the U.S. However, we have much stronger confidence that global central banks are finally appropriately focused on downside risks to growth, with only those officials most worried about inflation still chattering otherwise.

Q: Does this "less stout" view of the decoupling story mean that PIMCO expects the world to feel more pain from what is happening in the U.S. economy?

McCulley: The global growth decoupling trend, while still very operative on a long-term secular basis (see PIMCO's May [Secular Outlook](#)), is not nearly so robust on a cyclical basis. The more we debated, the clearer it became that growth decoupling and the current financial turmoil are highly interrelated. Depending on how nasty and drawn out the normalization process in credit markets becomes, global growth could become

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more interdependent. Put more bluntly, if America experiences a recession, the global decoupling story will likely pass through a tipping point into irrelevance. I repeat that a U.S. recession is not our baseline forecast, but it is a risk that we face.

Q: How does PIMCO expect the Federal Reserve to react to the risk of a U.S. recession?

McCulley: This re-intermediation process of moving assets and liabilities from the shadow banking system to the real banking system is unambiguously a tightening of credit availability, terms and pricing for the marginal borrower on Main Street. Thus, only a fool would conclude that growth in aggregate demand on Main Street will not slow, with a renewed leg down in home sales, home prices, and employment in associated industries playing the star role in the show. The supporting role will be played by a drop in consumer durable goods consumption – notably cars and hard goods that go into houses.

This is not a self-correcting process, but a self-feeding process. As Alan Greenspan recently intoned: while exuberance unfolds on the installment plan, fear unfolds on the wire. Self-feeding fear can only be broken by the Fed, using all available tools. Not just plumbing tools associated with the discount window and liquidity operations but old-fashioned cuts in the Fed funds rate – as many and as often as necessary to transform fear back into greed. So, the bottom line is that we are not looking for a recession, but a soft landing. It will be a bumpy one, but the runway will be lubricated by hefty Fed easing.

Q: With the Fed easing policy and a potential for global fallout from the U.S. subprime collapse, will the Bank of Japan (BOJ) be able to continue raising interest rates?

McCulley: In Japan, hope springs eternal that strong investment spending will be joined by sturdier consumer spending. But the data in this regard suggests that hope has little chance of turning into reality. The same holds true for prospects of a decisive, sustainable inflation rate above zero. The bottom line is that the BOJ's wish to normalize interest rates will remain just that – a wish – for a long, long time. This is particularly the case in the event of a nastier-than-expected global re-intermediation that promotes risk aversion and flight from yen carry trades, putting deflationary upward pressure on the yen and deflationary downward pressure on capital expenditures.

Q: At the March Forum, you noted the Euro zone was showing surprising resilience in the face of the U.S. growth slowdown. Is this still the case?

McCulley: In Euroland, the economy felt like it was booming six months ago. The reason Euroland growth has been near the top of its potential has been sturdy business confidence, manifest in robust capital spending – notably in Germany – aided and abetted by robust exports of high value-added capital goods to the emerging world – particularly Eastern Europe. But domestic consumer demand remains lackluster because globalization and internal labor market reform have allowed European corporations – especially in Germany – to short-change labor in terms of real wages. Nothing looks likely to change on the consumer income and spending front: the

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lackluster wage growth will continue because reduced labor bargaining power is a secular force with sturdy legs.

However, the new information now versus six months ago is that Europe's robust capital spending profile is no longer a certain outcome. Financial market turmoil in Euroland is every bit as bad as in the U.S., if not worse. Small companies that are short on cash and dependent upon small banks for investment funding are likely to retrench, at least relative to recent years. Meanwhile, the property bubble in Southern Euroland – particularly Spain – has gone bust not unlike the U.S. property market. Thus, the cyclical decoupling of European growth from the U.S., while still a viable story, will depend primarily on Europe's exports to the emerging market world.

Q: A decoupling between the U.S. and emerging markets has been a secular theme for PIMCO as well. How do you expect this growth relationship will fare during the shorter-term cyclical timeframe?

McCulley: The story for emerging markets is much as it's been for a long time, with improving domestic fundamentals, large stocks of self insurance in the form of foreign reserves, and the joy of riding a positive terms of trade shock from lofty commodity prices. While our long-term outlook is for these positive factors to sustain growth through internal demand, we're not quite there in the short term. Thus, while the emerging market world has gotten its financial house in order, it is still not running on home-grown Keynesian domestic-demand fuel. As Guillermo Osses articulately explained, only a heavy slump in demand from the developing world over three to six months is likely to spur some fiscal stimulation in emerging markets.

Mercantilism is a beast of burden that the developing world is not big enough or strong enough to preemptively abandon, even if they are not too blind to see the benefits of doing so. Thus, while we still maintain the global growth decoupling story for the long-term secular basis, it is not nearly so robust on a cyclical basis.

Q: What is PIMCO's latest view on China's growth and inflation?

McCulley: As always, China has slightly different dynamics than the rest of the emerging market world. Our cyclical view is that China will experience a different type of cause-and-effect than other emerging markets. The China juggernaut continues to have powerful momentum, but at the margin, the inflation picture in China looks a lot less comforting than it did six months ago. Food prices are soaring and wages are accelerating. This cyclical trend is no different from our longer-term secular outlook, where we expect China to become less of a disinflationary force over time. But at the margin, it implies that the weaker the global growth decoupling story gets, the more likely there could be a stagflation smell for China's economy over time.

Q: How are the conclusions from the September Forum influencing PIMCO's global investment strategy?

McCulley: Because we expect global central bank policy to be very active over the cyclical time frame, broad interest rate and curve strategies will be important. The Fed will lead the easing party, with other central banks following, either disposing of residual

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plans for further tightening or joining the Fed in reversing toward easier policy. That configuration implies steepening yield curves worldwide, or disinverting curves as the case may be. We also expect – particularly on days of acute global market turmoil – weakness for the U.S. dollar.

Volatility in credit markets and the repricing of risk premiums around the world are also opening up opportunities in places where spreads had been exceedingly tight just a few months ago. Cheaper risk assets – notably emerging market currencies and local rate debt – remain attractive as the cyclical global story morphs back toward our secular global expectations. There are similar opportunities in debt of select corporations in the developed world which have strong fundamentals, but have cheapened with the rest of the market.

Of course, these strategies all assume that there will be no major central bank policy mistakes in this critical cyclical time period.

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

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