

## Cyclical Forum

November 2007

### Rob Mead Discusses PIMCO's Cyclical Outlook and its Implications for Australian Investors



#### Robert Mead, CFA

Executive Vice President

Mr. Mead is an Executive Vice President, the Head of Portfolio Management in Australia and Head of Asia-Pacific Credit Portfolio Management. Prior to joining the Sydney office he was a Portfolio Manager for PIMCO Fixed Income Portfolio Management in Munich and Head of the European Investment Grade Corporates team. Mr. Mead joined the group in 2003, previously having been associated with Citigroup Asset Management in London as Global Head of Investment Grade Credit Research and Head of non-US High Grade Fund Management. Previously, he worked as a Corporate Bond Fund Manager for JP Morgan Investment Management in Melbourne, where he built a local corporate bond portfolio presence. Mr. Mead started his financial career as a credit analyst at Bankers Trust Australia. Mr. Mead has nineteen years of investment experience and holds a Bachelor's degree in Business from the University of Technology, Sydney, a Graduate Diploma in Applied Finance from Securities Institute of Australia and is a member of the New York Society of Securities Analysts.

*The U.S. subprime mortgage crisis has led to significant changes in global credit markets, even as healthy global growth cushions the impact of the slowing U.S. economy. In the interview below, Portfolio Manager Rob Mead discusses how PIMCO's six-to-12 month cyclical outlook for the global economy is influencing the firm's Australian outlook and strategy.*

#### **Q: What are the key trends that are shaping PIMCO's global six-to-12 month cyclical outlook, and how do they affect the outlook for Australia?**

**Mead:** The key to the current cyclical outlook is the slowing U.S. economy. The major elements related to this slowdown have been the subprime mortgage crisis, dysfunctional money markets, the credit crunch, widening of risk premiums, and the Federal Reserve's successive 50 basis point and 25 basis point interest rate cuts.

We believe the Fed's rate cuts have provided some temporary relief, but are not a long-term solution for the problems markets will likely face in the coming months. Many things still need to work through the system, such as the removal of assets currently sitting on banks' balance sheets as a result of underwritten loans that are yet to be syndicated, plus the unwinding of many structured transactions. As this process unfolds, we think volatility in markets will continue and will likely get worse. Some markets have been trying to ignore the stresses, but their time will come.

In Australia, there are very few subprime mortgages per se. But Australian investors have still been exposed to U.S. subprime asset-backed securities (ABS) through investment in structured products like collateralized debt obligations (CDOs). The impact of the subprime crisis on the global availability of credit has also affected Australian markets. The arrival of the subprime problem in Australia was evidenced by

## Cyclical Forum

November 2007

the high profile liquidation of a hedge fund run by Basis Capital Investments, which had heavily invested in CDOs, in addition to the pending sale of assets by RAMS Home Loan Group, which ran into trouble sustaining short-term funding amid the global credit crunch.

The key message for Australian investors is that even though the direct impact of U.S. subprime has been limited so far, the indirect effects are fairly substantial. The banking community within Australia is facing up to the reality that their cost of funds has gone up and they are passing those increases to borrowers, potentially causing rates for mortgage borrowers to rise even faster than the Reserve Bank of Australia's benchmark rate.

**Q: Given the U.S. Federal Reserve's recent rate cuts, do you think the Reserve Bank of Australia will follow suit?**

**Mead:** The Federal Reserve's response was partly due to problems in the money markets but also because the U.S. consumer is likely to come under significant pressure.

PIMCO believes that Australia is not even close to starting a monetary policy easing cycle, but as long as the U.S. is cutting rates due to a weak economy, it will be difficult for the RBA to continually raise rates. Currently, markets are priced for approximately two further rate increases. We believe that these market expectations are overdone, and that markets will reflect less RBA tightening over the months to come.

**Q: How much of an influence do you expect the U.S. slowdown to exert on the Australian economy?**

**Mead:** The global response to the U.S. slowdown is still playing out, but we believe that China and emerging Asia are among the drivers of world growth, and will be somewhat resilient to the U.S. cycle. Australia's closeness to China and emerging Asia, through geography and trade, will provide some cushion against the direct impact of U.S. weakness.

However, the U.S. economy remains the largest in the world, and a slowdown there will clearly have some influence in other parts of the global economy. For example, we expect that China's GDP growth will slow to single digit levels from the double digits we've become used to in recent years. Still, ongoing strength in China and emerging Asia will likely continue to help underpin global growth, making the impact of the U.S. slowdown less potent than it has been in the past.

Australia might be further protected by its strong fiscal position. Fiscal spending is already at levels considered stimulative for the Australian economy, and the upcoming elections will likely result in significant tax cuts over the coming years. The RBA is factoring this into its policies.

## Cyclical Forum

November 2007

For the election itself, we don't expect significant risks for financial markets one way or the other. The passing of the election, however, may provide the window for higher mortgage rates to be passed through to borrowers.

### **Q: What does PIMCO's outlook mean for Australian investors in global bonds?**

**Mead:** Credit spreads across all asset classes widened last quarter, and we think some widened by too much. We were a net buyer of riskier assets, like high yield bonds, bank loans and corporate bonds in August and September. Since then, the market recovered so we ceased buying additional risk through October. Still, we think volatility across all asset classes will continue in bouts over the rest of this year and into next year. This volatility will likely create opportunities for PIMCO, as assets that we previously thought were overvalued become fairly valued or even undervalued. We much prefer volatile markets to benign, trending markets, as these present much greater investment opportunities.

PIMCO has been forecasting the U.S. slowdown for an extended period – in fact too long, which has cost us. But now, with the scenario playing out, our conservative positioning has served us well, and we are strategically moving back into risk as we see opportunities.

Attractive real rates and ongoing economic strength in Australia are also creating opportunities in Australian bonds. We are now at a level where yields in the bond market are over 6.5% in the front end of the curve while inflation is running near 3%. While it remains to be seen whether double-digit returns in equities can continue ad infinitum, cash and bonds at their current levels are now much more competitive on a risk adjusted basis.

### **Q: In recent years, we've seen strong demand for alternative yield sources as distinct from traditionally defensive investments like government bonds. What has driven this trend?**

**Mead:** When Australian cash and bond yields were very low, there was a strong incentive for investors to look further afield for yield. However, recent market events have demonstrated that what some investors thought of as defensive assets have in fact entailed quite a bit of risk, and some portfolios have suffered accordingly.

While we agree it is justified to include some riskier, higher yielding assets in a diversified portfolio these should not necessarily be funded from government bonds or cash allocations which have completely different risk, liquidity and capital preservation characteristics. We think there is a real need to revisit the role of the defensive allocation in a portfolio.

As I mentioned above, this argument becomes even more compelling given the backdrop of risk free yields over 6.5% plus our expectation of continued market volatility.

## Cyclical Forum

November 2007

### Q: Thank you for your time, Rob.

**Past performance is not a guarantee or a reliable indicator of future results.** Each sector of the bond market entails risk. Some bonds may realize gains and may incur a tax liability from time to time. Any guarantee on government bonds is to the timely repayment of principal and interest. Shares of a portfolio that invest in them are not guaranteed. Mortgage-backed and asset-backed securities are subject to prepayment risk and may be sensitive to changes in prevailing interest rates. When rates rise the value generally declines. With corporate bonds there is no assurance that issuers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. 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.

A Collateralized Debt Obligation ("CDO") is a type of structured credit product and an asset-backed security. It is backed by bonds, loans, or another type of security. A CDO bond is backed by a diversified basket of portfolio of assets and can be interpreted as providing the investor with diversified exposure to the underlying asset class. The investments of the CDO are funded through the issuance of several tiers of securities, the repayment of which is linked to the performance of the underlying asset class that serve as collateral for the CDO liabilities.

This article contains the current opinions of the manager and 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. 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. ©2007, PIMCO.