

Secular Forum

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Mohamed El-Erian Discusses PIMCO's Secular Outlook and Investment Strategy



Mohamed El-Erian
Co-CEO and Co-CIO

Mohamed A El-Erian is Co-CEO and Co-CIO. He re-joined PIMCO in December 2007 after serving for 2 years as President and CEO of Harvard Management Company (HMC), the entity that manages Harvard's endowment and related accounts. Dr. El-Erian also served as a member of the faculty of Harvard Business School. Dr. El-Erian earned a B.A. in economics from Cambridge University and doctoral and master's degrees in economics from Oxford University. He spent 15 years at the International Monetary Fund (IMF) in Washington DC before moving to the private sector where he served as managing director at Salomon Smith Barney/Citigroup in London. In 1999, he joined PIMCO where he was a managing director and a senior member of PIMCO's portfolio management and investment strategy group.

In the interview below, Mr. El-Erian discusses the outcome of PIMCO's recent Secular Forum, an annual event that brings the firm's investment professionals from around the world together to formulate the three- to five-year economic outlook and investment strategy.

Q: What was the primary context and focus of the discussion at PIMCO's recent Secular Forum?

El-Erian: The Secular Forum is such a critical component of PIMCO's success over the years. Each May, PIMCO investment professionals from around the world come together for three days of active and wide-ranging discussions. The first two-plus days are spent listening to presentations from outside experts and to the fresh perspectives of our MBA recruits. Then we vigorously debate the issues and come up with testable hypotheses for the three- to five-year economic baseline, the investment implications, and the primary risk scenarios.

These secular views translate into what I call "rail guards." Think, if you like, of the seven-lane highways we have here in Southern California. The Secular Forum doesn't tell you which lane you should be in at any particular time, but it does tell you where the freeway is going and importantly, it gives you a feel for whether you're going off the road or not. In doing so, it provides anchors that guide you and guard against getting caught in popular short-term cyclical trade ideas that are unsustainable.

This year's Secular Forum was particularly interesting for two reasons. First, there is now strong evidence that we are in the midst of a secular realignment of the global economy. Second, it is always a challenge to separate short-term cyclical factors from long-term secular considerations, and here it was a particularly strong challenge because the past year has been full of dislocations and a series of unthinkable events including heavy losses on Wall Street, institutional failures and unusual policy reactions – some of which will have long-term effects.

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Q: What were the conclusions of the Secular Forum and how do they form PIMCO's three- to five-year outlook?

EI-Erian: We expect that the secular horizon will be full of handoffs – a growth handoff, an inflation handoff, a wealth handoff and an institutional handoff. And these handoffs will not necessarily be orderly. Therefore, getting the journey correct is just as important as getting the destination correct.

In terms of specifics, we came up with four testable hypotheses, meaning that in three to five years, we'll be able to look back and see whether they played out like we expected and if not, why not.

The first hypothesis is that, notwithstanding considerable cyclical headwinds, we expect the global economy as a whole to continue growing in a robust fashion over the secular horizon, with a continued shift away from the traditional drivers of growth – particularly the U.S. consumer – and toward emerging economies, several of which are now in a breakout growth phase.

Second, we acknowledged that the systemic impact of these emerging economies will be felt on both global production and consumption. Accordingly, we expect robust commodity prices, rising wage rates, and a series of policy responses in both industrial and developing countries that will contribute to inflationary pressures. Put another way, we believe that we are leaving the world of a secular disinflation and entering a world of higher inflationary pressures. Notice I didn't say inflation, but inflationary pressures – this is an important distinction. Third, we think that we are leaving behind the bullish run for corporate profits, starting with the financial sector and spreading to other sectors, overall and relative to labor.

Finally, we expect a significant realignment in the financial sector over the secular horizon, triggered by the series of crisis management decisions made in Washington in the midst of the Bear Stearns crisis and which will inevitably have long-term implications.

Q: Has PIMCO's secular view changed versus last year?

EI-Erian: It has evolved in view of new data. Indeed, the events of the past year have clarified our view of some turning points. In our previous Secular Forums, we emphasized the theme of a "stable disequilibrium" which described a world of massive global economic imbalances which, for a time and due to unusual circumstances, appeared stable. We noted that we were approaching a shift from stability to instability, which started last year.

Our previous secular investment theme was to position for a shift from the stable disequilibrium to an outright disequilibrium, which was to emphasize interest rate duration and minimize credit risk particularly in areas such as subprime. This worked very well for our clients' portfolios.

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Q: Is there a historical context to the current situation that is helping guide PIMCO's outlook?

EI-Erian: There is a context for the current process which, in simple terms, involves a forced sequential recapitalization of vulnerable sectors in the global economy. In 1997-2001, it was the turn of the emerging economies to be recapitalized after the Asian and Russian crises; the corporate sector followed in 2002-03 in reaction to the Enron and WorldCom debacles. Today, it is the turn of the financial sector. And over the next few years, the consumer will get recapitalized. So we see this as a sequential recapitalization process where various segments that got offside – because of a lack of discipline, excessive leverage or what was happening in the rest of the world – will get back onside.

For PIMCO, the question is not whether these recapitalizations happen, but whether they happen in an orderly or disorderly fashion. The fact that these recapitalizations are sequential is good news for the global economy, because if they were simultaneous, global growth could not be sustained.

Q: How do you expect the recapitalizations of the financial system, then the consumer, to play out?

EI-Erian: There was a lot of discussion in the Forum about the financial sector in the U.S. We expect that we will witness a period of continued shrinkage of balance sheets, higher economic and regulatory requirements for capital, and a higher degree of regulation.

The recapitalization of the consumer will follow after the financial system. The specifics of this process are highly dependent on how successful current efforts in Washington are in cutting off the downside risk of an even larger housing correction. Housing dynamics are very important. In addition to the strong role that inventories play in home prices, foreclosures can have a disorderly price effect by repricing entire neighborhoods to excessively low levels and creating an incentive for owners to just walk away from their homes. If this goes too far, it can be a very messy adjustment.

Because housing is the most important component of wealth for the consumer, much will depend on whether government policy is successful in stopping prices from a disorderly decline spurred by forced sales and foreclosures. So we are staying focused on what is coming out of Washington as this will be an important aspect in determining whether the recapitalization of the consumer will be done in an orderly fashion or disorderly fashion.

Q: What are the primary risks that go with PIMCO's hypotheses?

EI-Erian: Many of the risks can be viewed in terms of how the major areas in the global economy are going to react to the handoffs we've described.

The first is made up of the countries receiving the ball in the handoff, including many emerging markets and dominated by China, which has attracted so much attention over the past five years as its influence on the global economy has grown. We have to remind ourselves that China is the first case of a high growth country that has turned its terms of trade against itself – it exports manufactured goods where prices have been

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contained, and imports commodities, where there is a significant upward trend. The big question is if this will continue as-is, or if there will be a gradual policy shift in China as we expect.

We also believe that, in the risk assessment area, there are country-specific factors that the emerging world faces, under the notion that managing success is not easy. Inflation is an example which speaks to the broader issue that transformations are never smooth.

A third area of risk in this handoff relates to the overall global system – financial, trade, and political dimensions – and whether the system is able to accommodate all these changes. Can it accommodate China's breakout phase? Can it deal with the redeployment of surplus funds from countries such as China and Russia back into the U.S.? Can it deal with inequality? And can it deal with the pressure on the market infrastructure – the pipes on Wall Street – and on the policy side?

Q: What about risks in the developed world?

EI-Erian: One of the biggest risks in the developed world is protectionism. All of the transitions, handoffs and recapitalizations that underlie our secular hypotheses rely on the lubrication provided by capital flows and trade. Protectionism, which comes in a variety of forms, can restrict this, posing a risk to orderly changes.

Additionally, for the areas running deficits – primarily the U.S. – the major issue is how the consumer will handle the four headwinds that are growing in strength: lower credit availability, disappearance of the equity withdrawal mechanism because of the decline in housing prices, higher energy and food prices, and declining employment. The general feeling is that U.S. fiscal policy will step up and take some of the pressure off consumers' balance sheets. But we also recognize that this is a very difficult time for policy makers because they are simultaneously dealing with inflation for goods and services, deflation in asset prices and declining economic growth. So a major risk is that fiscal policy will be too slow to react, and that the Fed will remain the only game in town.

We also discussed non-economic factors such as climate change, global inequality and geopolitical risks.

These are also risk factors. After debating all this, we ended up with the preponderance of evidence that the handoffs will be successful over the medium term. But it will be a bumpy journey, with episodes of market accidents and policy slippages.

Q: Is leverage in the financial system still posing a major risk for markets?

EI-Erian: We talked about leverage, and most of the talk continued to center around the evolution of the "Shadow Banking System," a phrase used by Bill Gross and Paul McCulley to describe the entities and activities that took on substantial leverage backed by insufficient capital and outside sophisticated regulatory oversight. What we've seen is a forced deleveraging of part of the shadow banking system that has been created by a combination of mark-to-market volatility and a need to minimize losses in the

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context of the “just in time” risk management mindset that dominated Wall Street until last summer.

There is another part of the shadow banking system – instruments that are still rated AAA but do not deserve the rating – that has yet to delever. For now, these are subject to less frequent mark-to-market and rating agency actions. Ultimately, for these instruments, it’s a horse race between continued deleveraging and the entry of new capital to recapitalize.

Over the longer term, we expect a realignment of the financial sector, driven by factors such as the Fed’s decision on March 16 to open its funding window to investment banks. It will be hard for the Fed to withdraw the window. Instead, access to the window will be accompanied by more regulation and higher capital requirements than we’ve seen in the past.

Q: What is driving the strength in commodity prices? Is it short-term cyclical forces or long-term secular trends?

EI-Erian: When we look at commodities, we distinguish between long-lasting influences and short-term momentum effects. In terms of lasting effects, we believe that the demand curve for commodities has shifted due to growth in emerging economies. This shift is having a continuous effect, day-in and day-out. As they get richer, these countries understandably are also looking to build up precautionary stocks just like industrialized countries have, which amounts to more incremental demand.

This combination tends to attract momentum buyers and trigger individual country and company responses that can make prices move very sharply initially.

So we are in the midst of a secular shift in demand for commodities that is being accentuated and made volatile by all of these short-term reactions.

Q: How does PIMCO expect inflation pressures will be distributed among the major players in the global growth handoff, and how does the short-term cyclical view differ from the long-term view?

EI-Erian: The perception of inflation from a shorter-term cyclical view depends on where you are sitting in the globe. If you are in the U.S., you don’t pick much up in core inflation, which excludes certain elements such as food and energy, but you pick it up in terms of headline. If you happen to be sitting in an emerging economy – particularly one with a fixed exchange rate – then you are picking up a lot of inflation. That reflects competing influences. In countries where the inflationary pressures are combined with a significant asset price deflation and sluggish employment, like the U.S., you get a significant dispersion between core inflation and headline inflation. If you go to other countries that are growing rapidly, you don’t get that.

So the cyclical inflation outlook is nuanced. Over the longer term, we think that there will be convergence.

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Q: What will be the source of further dollar weakness?

EI-Erian: We believe that there will be renewed dollar weakness after this cyclical retracement, but it will be different from what we've seen over the past several years. There will be a significant change in the currencies that carry the appreciation burden in the global system. For reasons I outlined earlier, we believe that a growing number of emerging economies will shift to more flexible exchange rate systems.

Q: What are the investment implications of PIMCO's Secular Outlook?

EI-Erian: As I mentioned before, the global movement from stable to unstable disequilibrium is driving our view that the major drivers of return are going to shift over the secular horizon from interest rate duration to what we call spread duration, which involves cautiously harvesting various credit risk premiums. But we made a very important qualification: to use an American football analogy, this is not the time to go from defense to offense big time; it's time to go from defense to special teams. This means that we have to pick our spots very carefully because of the recognition that the journey will be bumpy.

Where do we believe we will capture risk premiums? We are looking to credit spreads in sectors where recapitalization is closing the gap with deleveraging. We know that deleveraging for many sectors started and has accelerated over the past year. Now the recapitalization process is in play in some areas. In the immediate term, this leads us to think about the senior parts of the capital structure in the financial sector. It's a different situation for equities which will likely face pressure on account of dilution and lower returns on equity (ROE) due to deleveraging.

We're also continuing to look for high growth areas around the world, especially market segments that are being completed as these countries mature. We expect a period of renewed dollar weakness over the secular horizon, but we won't be seeking to exploit these opportunities through already floating currencies such as the euro, as we have been in recent years. Rather, we will be looking to invest in currencies that are currently subject to fixed or managed regimes but likely to become more flexible over the medium term.

Q: Thank you, Mohamed.

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