

**Spotlight**

October 2007

**William C. Powers Discusses PIMCO's Cyclical Outlook and Global Strategy****William C. Powers**

Managing Director and Senior Member of PIMCO's Portfolio Management and Investment Strategy Groups

Mr. Powers joined the firm in 1991, previously having been associated with Salomon Brothers, and with Bear Stearns as senior managing director, specializing in mortgage-backed securities. Mr. Powers has 20 years of investment experience, and holds a bachelor's degree in economics from Princeton University and an MBA from Stanford Graduate School of Business.

*Bill Powers is a senior member of PIMCO's Portfolio Management and Investment Strategy groups, and plays a key role in formulating the firm-wide viewpoints that shape every PIMCO portfolio. These views are guided by PIMCO's cyclical Economic Forums, which examine the outlook for the next six to 12 months, and the annual Secular Forum, which focuses on the three-to-five year outlook. Paul McCulley recently discussed the major conclusions from PIMCO's September Cyclical Forum, and in the interview below, Mr. Powers discusses the details of the firm's global outlook and investment strategy following the September Forum.*

**Q: Before we discuss the investment implications of PIMCO's September Cyclical Forum, would you summarize the firm's key conclusions from the Forum?**

**Powers:** The key change in our cyclical outlook is that the contagion risks associated with the decline in the U.S. housing market have now become outcomes. The question of whether or not the deterioration in housing would spread to the broader economy and financial markets is now a question of how widespread and severe the contagion will be and how long will it last.

Currently, the economic damage has mostly been contained to the U.S. At the September Forum, we debated whether that will remain the case, with slower growth confined to the U.S. and with the policy response remaining U.S.-centered as opposed to spreading to other economies such as the U.K., Europe, Australia, Japan, Canada and the emerging nations. Our secular view is that the developing world will continue to grow at 8%-11% despite much slower growth in the developed world in the area of 2%, allowing the global economy to continue growing at 4%-5%. Within the developed world, those economies with debt-burdened consumers and mortgagors, including the U.S., U.K. and Australia, will be suffering more.

At the September Forum, we concluded that this decoupling trend in global growth remains intact. If hard landings in housing markets lead to hard landings in developed world economies, China and countries exporting to China – including Germany, Asia ex-China and Brazil – risk at least a slowdown in their domestic economies. However, at this point, we are not calling for a recession in

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the U.S. or a global hard landing scenario that would significantly slow growth in the developing economies.

**Q: Given the firm's cyclical views on global growth, where does PIMCO see the most attractive return potential in the global bond market?**

**Powers:** The contagion from the housing market is moving deeper into the U.S. economy. Of note, this slowdown is only two months into what is likely to be a long period of slower growth. Until now, U.S. consumption has maintained steady growth at 2.75% to 3% despite the severe problems in subprime mortgages. Looking forward, when an extremely rare national decline in housing prices, potentially of a 5%-10% magnitude, combines with prime jumbo mortgage rates that are now 6.5%-8.5%, the economy will likely have to endure 10%-20% real housing loss figures net of housing price appreciation and mortgage expense. That is an enormous burden and a stark contrast to the recent succession of double-digit annual home price appreciation financed by low annual housing outlays. The large reduction in mortgage equity withdrawal (MEW) has left consumers with fewer resources to maintain consumption. PIMCO predicts that effects on consumer confidence, consumption and hiring are likely to surprise in this new environment, especially given low savings rates and the lack of affordability of U.S. housing at current prices.

Over-levered mortgagors in the U.S. are likely to be joined by those in the U.K. and Australia as rate resets coming due over the next year or so pinch the mortgagor/consumer, risking distress in housing markets that are also historically expensive. The risk of housing contagion affecting consumption is certainly increasing in these markets as well, although not at U.S. levels. Hence, when we look at the range of effects this cyclical slowdown will have on individual countries, we see the biggest effect in the U.S., followed by the U.K., and then Australia. After these three, Canada is next, Japan is far behind, and the European economy is thought to be the least likely to slow.

As the issues remain largely U.S.-centered, the market appropriately continues to expect the bulk of the policy response to occur in the U.S. The market is not currently expecting other central banks to ease substantially, but markets have ruled out a continuation of tightening cycles. We believe policy response will have the largest impact on the yield curve in the U.S. We continue to focus on the front end of the U.S. yield curve, but also favor the front end of the curve in the U.K. and Australia, where some expectations for either further tightening or relatively high front-end funding rates are unlikely to sustain themselves.

**Q: On a secular basis, PIMCO is bearish on the U.S. dollar and favors emerging market currencies as global growth shifts toward the developing world. Given the recent decline in the dollar, what are PIMCO's cyclical views on the currency markets?**

**Powers:** From a currency perspective, we expect policy responses in the front-end to negatively affect the currencies of those countries that are easing or not likely to tighten as much as the market now expects. Hence, we believe the U.S. dollar remains vulnerable. By contrast, our overwhelming preference is for emerging market (EM) currencies, based in part on our secular views but also,

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importantly, PIMCO is not predicting a hard landing scenario that would severely affect the developing economies. In particular, we continue to favor the Brazilian real, the Mexican peso and the Russian ruble.

EM local currency bonds did not perform well during the period of risk aversion in August. Since the peak of the August risk aversion, EM currencies have recovered. We expect EM local bonds and currencies to perform well in the future as markets embrace the decoupling theme – that problems in the U.S. are unlikely to spread to the developing world.

Looking at other currencies, the euro appears expensive but can be expected to appreciate versus the dollar as the Fed funds rate and the European Central Bank's policy rate converge at perhaps 4%. The British pound is expensive and vulnerable to problems in the U.K. housing market and risks of lower consumption. China is expected to maintain 4%-5% annual appreciation in its currency, the RMB, in an effort to maintain policies relating to growth that rely upon a cheap currency. Most importantly, China needs to create jobs for 25 million new workers per year. The yen, given low short-term rates in Japan, is a significant negative carry currency, but will benefit from bouts of risk aversion. The primary currency theme is a weak U.S. dollar and strong emerging markets currencies.

**Q: PIMCO has been very cautious on corporate bonds and other credit because of concerns about valuations. Given the rise in credit spreads, does PIMCO now see value in corporate bonds or other credit instruments?**

**Powers:** For the first time in a long while, we have shifted our strategy in credit from an underweight to a slight overweight. At recent forums, we have noted that credit was trading at abnormally tight spreads because of a global glut of liquidity and bids from structured products for corporate exposure. Spreads were extremely tight and vulnerable to significant widening not only in corporate bonds but also in asset-backed securities and other credit assets. We have now seen an adjustment in the pricing of corporate debt, normalizing compensation for credit risk. Corporates are much less overvalued today.

Recent corporate bond and bank loan deals have come at attractive new issue concessions. Also, high quality, money-good asset-backed securities and non-agency mortgage-backed securities have been offered at distressed prices, giving us an opportunity to reduce our underweight in credit concentrations and begin shifting to a slight overweight. We have been buying new issues and we have been selectively buying secondary market credit positions.

**Q: With the Fed and other banks stepping in to ease the disruptions in the credit market, why isn't PIMCO moving more aggressively into credit now? Does the firm see additional opportunity in the future?**

**Powers:** With the Fed having recently eased by 50 basis points, one is tempted to think that the worst is behind the market. The markets are much calmer than they were during the disruptions, fears, uncertainties and rumors at the end of July and at the beginning of August. This view might motivate moving portfolios to a significant overweight in corporate credit. We note, however, that the U.S. is

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only two months into a perhaps multi-year correction. Some of the corrosive effects of the housing market on the consumer and on hiring are still ahead of us. We are opportunistic, but remain cautious and defensive.

Our portfolio strategy starts with a defensive thesis where one goal is to avoid underperformance in volatile periods of risk aversion like we saw in July and August. Hence, we want to maintain dry powder to judiciously add risk in periods of turmoil and distress in the credit markets. Perhaps there are multiple bottoms in credit ahead. We also remain cautious on high yield corporates, which have, by and large, performed relatively well through this initial stage of the credit turmoil. The lower tiers of high yield are vulnerable if the credit cycle becomes more severe given instances of lax underwriting and vulnerabilities to a sustained business cycle slowdown. We remain wary. We continue to favor the higher-rated sectors of the high-yield market and are avoiding select CCC and B rated bonds, as well as those with little or no covenant protections for bondholders.

**Q: Does PIMCO's thesis – structuring the portfolio with the goal of performing well in periods of market distress – apply to PIMCO's duration strategy as well?**

**Powers:** Yes. We are looking to maintain a modest bullish posture with respect to interest rates in our portfolios, with the goal of generating excess returns in periods when the yield curve steepens and rates decline. Our view is that rates are more likely to decline than trend back to recent highs now that the cyclical slowdown is confirmed. PIMCO's structural heritage is to avoid the most expensive bonds -- the most liquid, lowest yielding Treasury bonds. After the tremendous move in Treasuries over the last couple of months, Treasuries appear expensive. We prefer sectors that have lagged the decline in Treasury rates, including swaps, mortgages, emerging markets, the U.K. and Australia. At some point, perhaps soon, the surplus portfolios and sovereign wealth funds will take notice of this value opportunity and diversify out of Treasuries into spread products.

Despite a bullish posture on interest rates, duration is expected to make only a very modest contribution to our portfolio returns. Our yield curve strategy remains a larger driver of performance. A review of prior Fed easing cycles shows that a curve steepening of two-year notes versus 10-year notes contributes more powerfully than a bet on rates. One should prioritize curve exposures versus duration exposures.

**Q: PIMCO also has a structural preference for selling volatility by holding mortgage-backed securities or through options strategies. Given the recent volatility in financial markets, what is PIMCO's view on selling volatility as an investment strategy?**

**Powers:** Volatility assumptions and premiums were among a list of premiums that had declined to historically low levels. As volatility has crept back into the market, prospects for volatility sales look more interesting going forward. We will be targeting volatility sales primarily through holding overweights in mortgage-backed securities, which have become very cheap versus Treasuries and swaps. However, we are also aware that volatility spikes can occur as we go through this

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cyclical slowdown and repricing of risk spreads and premiums. Hence, we will limit our overweight mortgage exposure for now in order to maintain room to add during volatility spikes. Other volatility sales will be selectively employed as opportunities present themselves, consistent with our historical bias for volatility sales.

### **Q: What is PIMCO's view on Treasury inflation-protected securities (TIPS)?**

**Powers:** There were two sides to our debate on TIPS at the September Forum. On the one hand, we are currently in the midst of a disinflationary trend as the U.S. economy slows, with the Fed's preferred inflation measure – the core personal consumption expenditures deflator – expected to decline from 1.8% to 1.5% over the next 12 months. In a disinflationary environment, we would expect TIPS to underperform Treasuries as real rates decline, perhaps toward 1%.

On the other hand, the Fed has had to subordinate its inflation concerns in order to address the potential contagion effects from the meltdown in housing and turmoil in the credit markets. As the Fed lowers the Fed funds rate into stimulative territory and pauses until the housing market and the economy right themselves, PIMCO's secular forecast for higher inflation will become the market's primary concern. In that environment, or over the longer term, we see the potential for TIPS to offer relative value versus Treasuries.

### **Q: Municipal bonds underperformed Treasuries during the flight to quality that occurred in August. Does PIMCO see opportunity in munis given their recent underperformance?**

**Powers:** Munis severely underperformed Treasuries in August as their prices moved in the opposite direction from Treasuries. The underperformance in munis was not related to credit concerns in the municipal sector but to a lack of liquidity due to credit and liquidity problems in other sectors of the bond market. Thus, we see some opportunity in munis as a crossover strategy in non-muni portfolios. We expect attractive pricing on new muni issues, notably ones backed by tobacco revenues that are expected to come to market in the near future. However, the supply of new issues in the muni market is limited and we do not anticipate a significant increase in our muni concentrations given the lack of supply.

### **Q: Thank you, Bill. We look forward to speaking with you again after PIMCO's next Cyclical Forum in December.**

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are subject prepayment risk. The value of some mortgage- or asset-backed securities may be particularly sensitive to changes in prevailing interest rates; when interest rates raise the value of the security 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 non-U.S. securities may entail risk as a result of non-U.S. economic and political developments, which may be enhanced when investing in emerging markets. Currency rates in non-U.S. countries may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. Duration is a measure of a bond's price sensitivity to interest rates and is expressed in years. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

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