

Spotlight

March 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 22 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 March Cyclical Forum, and in the interview below, Mr. Powers discusses the details of the firm's global outlook and investment strategy following the March Forum.

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

Powers: The highlight of our latest Cyclical Forum is our reduced inflation forecasts and slightly higher growth forecasts for the U.S., Europe and Japan. For the U.S., we expect core inflation—as defined by the core PCE deflator¹—to average 1.9%, down from our 2.2% forecast following the December Forum. In Euroland, we reduced our core CPI forecast to 1.8% from 1.9%. For Japan, we reduced our core inflation forecast to -0.2% from 0.2%.

We raised our U.S. GDP forecast to 2.2% from 2%, our Euroland GDP forecast to 2.6% from 2.1%, and our Japan GDP forecast to 2.1% from 2%.

This forecast removes some of the stagflation characteristic of our December forecast, essentially removing consideration for rising inflation. We advance the transition of global growth rotating away from the U.S. towards the rest of the world.

Q: How are the conclusions from the March Forum influencing PIMCO's views on the timing of Fed easing?

Powers: The Fed is giving the U.S. economy every benefit of the doubt. It sees moderating growth from weaker housing and autos as a virtue because of the potential benefits of lower inflation. Considering the Fed's risk-management perspective, we thought a deteriorating economy would be a bigger risk than the Fed would accept given the risks of a recession in a low rate environment. However, the Fed is concerned that core inflation has not fallen into their 1% to 2% comfort zone at any time during the last three years and that unemployment is 4.5%, suggesting limited slack in the economy and the potential for sticky inflation at high levels. Thus, the bar is set very

¹ The core PCE deflator is the personal consumption expenditures index, excluding food and energy.

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high for a Fed ease and we are persuaded that June is too soon for an ease. Unless the recent market turmoil progresses, the Fed will be on hold until August.

By August, the Fed will have five more months of employment data, which we believe will reflect deteriorating employment conditions due to the slowing housing market and a reversal of the positive effect of warm weather in November, December and January. The Fed will be more comfortable easing when the core PCE deflator is below the 2% high end of its comfort zone and when unemployment is closer to 5%.

Q: What is PIMCO's outlook for monetary policy in the euro zone and U.K. following the March Forum?

Powers: The U.K. currently has no core inflation threat but the Bank of England's Monetary Policy Committee (MPC) would prefer to see headline inflation moderating to a level well below the 3% threshold. The market recognizes the possibility of another tightening by the MPC from 5.25% to perhaps 5.5%, but PIMCO does not expect another move.

The European Central Bank (ECB) has continued its hawkish rhetoric with its move to 3.75% from 3.5%, which has raised expectations for a tightening to 4%. We agree that there is a strong likelihood that the ECB will move to 4% in June, due mostly to the hawkish character of the ECB. We do not think a move to 4% is necessary. Our forecast is based on the ECB's desire to remove inflation threats by using opportunistic disinflation to further reduce future inflation risks. If the ECB tightens, it will be only one more time. We think once the Fed eases, all major central banks will pause.

Q: PIMCO's latest forecast calls for inflation in Japan to remain very low. How is that forecast affecting the firm's view of future tightening by the Bank of Japan (BoJ)?

Powers: The BoJ's pause in January alerted the market to the tension between the BoJ's stated desire to normalize policy and its concern for the low level of inflation. Our forecast, which includes some negative inflation prints during 2007, speaks to the very low inflation conditions in Japan despite a very high fourth quarter GDP print of 5.5% annualized.

The high GDP report does not give rise to inflation concerns in Japan. Additionally, the BoJ had been concerned about asset prices, but the turmoil in the Japanese stock market and lack of broad real estate price increases make this source of inflation threat remote, if not removing the threat entirely.

We do not expect the BoJ to tighten before the upcoming elections in the third quarter. By then, we expect the Fed will have reached its conditions for easing, which would make it extremely difficult for the BoJ to normalize monetary policy while the Fed is easing. Hence, it is quite possible that the BoJ has no opportunity or motivation to tighten, between the elections and the onset of the Fed easing, and may find itself finishing 2007 at a below-consensus 0.5%.

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Q: Expectations that the Fed will begin cutting interest rates have been a key part of PIMCO's investment strategy. With the Fed unlikely to ease before the August meeting, has PIMCO adjusted its investment strategy?

Powers: Volatility has been very low in the market and is likely to remain at low levels until there are signs of increasing turmoil in the markets, which could come about as a result of further deterioration in global stock markets and risk appetites or further deterioration in the U.S. housing market or employment data.

If these factors are not going to prompt the Fed to ease until August, that gives us confidence to continue holding an overweight in mortgage-backed securities, which we think are vulnerable to volatility spikes and a turn in the business cycle, through at least the next quarter and perhaps beyond that.

Regarding yield curve strategy, our strategy of favoring the short-end of the U.S. curve has benefited recently from the turmoil in the market and the removal of the expectation that briefly entered the market that the Fed would make an additional tightening move. The market is now reasserting its expectation that the Fed has three eases in store over the next year, returning the front-end of the curve to a position very similar to that in our last conversation in December.

While we have moved out our forecast of the first Fed ease from the June meeting to the August meeting, we are less focused on the timing of the first ease than the magnitude of the cumulative eases. The magnitude of the cumulative eases is likely to be 125 basis points or more. We still see the Fed funds rate in the mid-3% to 4% level in 2008, creating a strong incentive to remain with a concentration at the front-end of the yield curve.

Q: In terms of yield curve strategy, where does PIMCO see value outside of the U.S.?

Powers: Similar to the U.S. yield curve, we would argue that yield curves in the U.K., Australia and New Zealand are likely to benefit from similar expectations of moderating economic growth and inflation, though we do not expect policy responses to be as large as that of the U.S. While there are still prospects for further rate increases in Europe and Japan, we also see some value in the front-end of these yield curves as well.

Q: How are the conclusions from the March Forum influencing PIMCO's duration strategy?

Powers: As we approach this business cycle turn, we expect to increase our duration overweight from recent targets, which were one-half to three-quarters of a year, to three-quarters of a year to one-and-a-quarter year.

We are also focusing on the costs and benefits of implementing our strategy with hard duration versus soft duration. Let me explain what I mean by hard versus soft duration. Hard duration refers to those instruments that will lead the market during a decline in rates. Among those would be swaps, futures and Treasuries. We describe soft duration instruments as those that would have positive but lower correlation with a declining Fed funds rate. Those would include Europe and Japan, as well as sectors like TIPS, municipal bonds, and mortgages, which tend to outperform in periods of stable to rising

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rates but underperform in periods of falling rates. Hence, we will have limited tactical positions in Europe and Japan, as well as in TIPS, munis and mortgages, particularly as we approach the point where we believe the Fed is likely to ease.

Q: Has the March Forum prompted any changes in PIMCO's view of the U.S. dollar?

Powers: Of our top five portfolio positions, our favorite is our short U.S. dollar exposure. We have a target of 3% short U.S. dollar exposure, which is towards the high end of our range of currency exposure.

The unwinding of yen carry trades should benefit the yen versus the dollar. With the dollar at 118.11 the yen certainly has a lot more room to appreciate. The impetus for a decline in the dollar versus the yen remains the convergence of the large front-end rate differential. The slowing of the U.S. economy and Fed eases will likely be the catalyst. Rate convergence is coming exclusively from the U.S. as Japan may pause at 0.5%. A reasonable target for the yen in 12 months is 105.

The euro would be our second pick versus the dollar. We think the euro provides diversification benefits in our currency strategy, but we also note that, for the first time in a while, we are forecasting that European growth is going to be higher than U.S. growth. Hence, the rotation of growth away from the U.S. towards other parts of the world, including Europe, should benefit the euro. Rate convergence between the Fed and the ECB, with both perhaps meeting at 4%, would also benefit the euro. A reasonable target for the euro in 12 months is 140.

We are also positive on a basket of emerging currencies, including China's currency, the RMB, and the Russian ruble, which together with other countries in the emerging basket constitute the balance of our currency exposure. We will look to implement some cross-currency positions, including the Australian dollar versus either the New Zealand dollar or the Canadian dollar, and within Europe, long Norway versus short U.K. sterling.

Q: What is PIMCO's view on corporate bonds?

Powers: Our issue with corporate bonds has been primarily the low level of spreads and the market's expectation of low default levels. Our economic forecast is that default frequency will be increasing. In a rising default environment due to an economic slowdown and with profit levels declining, there is room for spreads to widen, perhaps substantially, from very low levels. We are looking to keep our powder dry in anticipation of opportunities to acquire corporate bonds at wider spreads.

Q: Has the firm's view on emerging markets changed at all following the March Forum?

Powers: Conditions in emerging markets have not changed much since we spoke in December. We continue to observe the journey of the emerging market countries on their path to rating upgrades, primarily through the buildup of large reserves and very disciplined fiscal and monetary policy. That journey remains intact. What is missing are attractive spreads in some of the dollar-based emerging markets.

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While spreads are very modest in credit default swaps with maturities of two years or less, and in our top emerging picks, these spreads are less vulnerable to a U.S. economic slowdown than in the past. Given the dramatic buildup of reserves and the sparse calendar of debt issuance coming from these countries—in many cases, their financing for 2007 is already finished—and with few maturities coming due over the next two years, we think these credits are very stable, if not improving. While current spread levels make us cautious, we believe there are still reasons to selectively garner the modest spreads that are available.

Q: You mentioned earlier that municipal bonds are not likely to benefit as much from Fed easing as other forms of duration, but does PIMCO see value in the municipal bond market?

Powers: There are some negatives in the muni market but there are positives as well. One of the positives is a non-inverted muni curve. Hence, the front-end of the muni curve has less negative carry than the front-end of the U.S. Treasury market. Second, some sectors of the muni market, including zero coupon munis, are still cheap and represent potential value. Third, with political momentum swinging toward the Democrats, we expect that the tax advantages munis offer will ultimately be in greater demand.

Another factor that favors munis is that if the turmoil in the stock market continues or increases, assets like munis that are less volatile would likely benefit as a result. Also, if overseas holders of U.S. dollar fixed income assets reach a saturation point, there are not munis in overseas portfolios to sell. Hence, there is no absorption risk of munis coming out of overseas portfolios as there is with U.S. Treasuries or agencies.

Finally, we expect that the U.S. budget deficit will increase with a slowdown in the economy, leading to more Treasury supply at a time when overseas portfolios are reaching their saturation point. In that scenario, munis could outperform Treasuries.

Q: Given PIMCO's reduced expectations for inflation, what are the firm's views on inflation-linked TIPS?

Powers: We do not expect interest rates to fall to the lows of 2003, when there was a higher deflation risk than we expect in the upcoming environment, but we note that breakeven levels of TIPS versus Treasuries during that period were as low as 1.5%. If you were to extrapolate from existing rate levels, that means a move of 140 basis points in 10-year Treasuries could see breakeven inflation levels declining by 85 basis points, which speaks to a fairly large potential underperformance of TIPS in any downward rate move.

With the possibility in the next 12 months that there could be a rate decline in 10-year Treasuries to at least 4%, now would be a time to move out of overweights in TIPS to a flat posture.

Q: With the Fed continuing to express concerns about inflation, is PIMCO hedging its bet that U.S. short-term rates will fall?

Powers: Yes, and diversification is a big part of that bet. Japan has positive carry and could be expected to do well if the U.S. economy were to regain strength and the Fed

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were to remain on hold, moving Eurodollar rates back toward 5% or perhaps higher. In that scenario, positions in Japan would be a very effective diversifier.

In addition, positions in mortgages provide carry in the portfolio and in a rising interest rate environment we would expect overseas investors to ramp up their accumulation of mortgages as a diversifier. We also believe the U.K. yield curve will normalize, or disinvert, in this type of environment as well, which should favor curve steepening strategies in the U.K.

Having said that, at this point, we do expect the Fed to ease in August and we expect the cumulative magnitude of Fed eases to be far greater than what is discounted by the market. We are not looking to hedge our entire bet.

Q: PIMCO recently made some changes to the investment process that follows the Forums. What were the changes and why did PIMCO make them?

Powers: As a global firm operating in many regions and specialty sectors within the fixed income market, our investment process needs to evolve to ensure that it remains as efficient as possible. It is critical that we stimulate idea generation by our local teams around the world and our sector specialists.

Our latest evolution in this process is to change the order of our quarterly meetings. As always, we start this process with regional economic forums, which are followed by our global forums in Newport Beach where all portfolio managers benefit from the same debate, discussion, analysis and forecasting of global economic conditions by PIMCO's Investment Professionals.

In the past, following the Forum, the Investment Committee would refine our internal forecast and our top-down views on duration, yield curve, volatility and credit. The Investment Committee would then share those views with our local teams around the globe and our specialty sector teams, who would then use the Investment Committee's views as a framework and filter for developing their own investment strategies.

This last quarter, we changed the order of our meeting schedule. Our regional and sector specialists now put forward their own viewpoints without input from the Investment Committee so that all can benefit from an unbiased view of value and risk in regional markets and sectors. The Investment Committee then meets with each of the local and sector teams to hear their favorite strategies for delivering value to our clients. It is only at the end of the process that the Investment Committee meets to put together its portfolio.

This approach offers several benefits. One benefit is that we get a much broader range of ideas from individual portfolio managers and from the regional and sector teams. Second, the Investment Committee benefits from the work that these teams do before we sit down to develop our own portfolio strategies. Third, this approach provides the local and sector teams with a higher degree of freedom in implementing strategies when they would prefer a different mix or timing of strategy implementation or find the Investment Committee ideas, in either timing or relative value, less compelling than other ideas put forward by our regional and sector experts.

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However, while there is an increased tolerance for a range of ideas beyond the tolerance that was previously in place, the caveat is that portfolio managers will consistently be on the same side of trades. One group will not be long what another group is short. The choices are in scaling and selection of PIMCO strategies.

Q: How might this approach work in practice given PIMCO's current views?

Powers: We can look at the range of views on the current outlook as a continuum, with the Fed on one end of the continuum remaining confident that the recent market turmoil and economic moderation is nothing more than a healthy correction—a healthy introduction of risk premiums in markets that had become very complacent. At the other end of the continuum, you have some members of PIMCO's Investment Committee who believe that this turmoil is an omen, a corrosive and contagious deterioration of the U.S. economy with risk appetites preparing to go on perhaps a severe diet.

We have portfolio managers at PIMCO who fill out the continuum, between the Fed's rather confident view and the concern of some on the Investment Committee and elsewhere in the firm that the conditions for a slowdown are in place, and the externalities of excesses in the economy and markets potentially severe.

Ultimately, the prospects for fixed income markets and the level of volatility will be determined by whether economic data in the future is mixed or unambiguously weak. We provide some tolerance for our portfolio managers to express their view based on where they are on this continuum. For example, a portfolio manager who believes we are on the express train to recession will reduce mortgage exposure and implement positions that may benefit from volatility levels rising and rate levels declining sooner rather than later. Those who expect very little contagion and a soft landing will express their view by maintaining overweights in mortgages and perhaps selling volatility elsewhere in the portfolio, even with low volatility premiums.

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

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investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

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