

## Secular Forum

May 2009

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



**Mohamed A. El-Erian**  
CEO and Co-CIO

Dr. El-Erian is CEO and co-CIO of PIMCO and is based in the Newport Beach office. He re-joined PIMCO in 2008 after serving for two years as president and CEO of Harvard Management Company, the entity that manages Harvard's endowment and related accounts. He first joined PIMCO in 1999 and was a senior member of PIMCO's portfolio management and investment strategy group. Before coming to PIMCO, Dr. El-Erian was a managing director at Salomon Smith Barney/Citigroup in London and before that, he spent 15 years at the International Monetary Fund in Washington, DC. Dr. El-

Erian has published widely on international economic and finance topics. His book, "When Markets Collide," was a New York Times and Wall Street Journal bestseller and won the Financial Times/Goldman Sachs 2008 Business Book of the Year. Dr. El-Erian has served on several boards and committees, including the U.S. Treasury Borrowing Advisory Committee, the International Center for Research on Women, and the IMF's Committee of Eminent Persons. He is currently a board member of the NBER and the Peterson Institute for International Economics. He holds a master's degree and doctorate in economics from Oxford University and received his undergraduate degree from Cambridge University.

*In the following interview, Dr. El-Erian discusses the outcomes from PIMCO's recent Secular Forum, an annual event that brings the firm's investment professionals from around the world together to formulate the firm's three- to five-year economic and market outlook. We also include outside experts that help frame our discussion and add insight on key factors that are part of our debate. The secular outlook guides the firm's investment strategy, product development, client servicing and business management.*

**Q: A lot has happened since PIMCO's 2008 Secular Forum. How did the progression of market, economic and policy developments over the past year frame PIMCO's 2009 debate?**

**El-Erian:** Three issues defined the context for this year's Secular Forum. First, we found ourselves drawn back to the 2008 Secular Forum's characterisation of the global system as having reached a "dead end:" unable to continue on its recent path due to debt exhaustion and poorly capitalised activities, yet also incapable of embarking smoothly on a different path as the ravages of de-leveraging result in disruptive overshoots and considerable collateral damage.

Second, we recognised that the global economy and markets suffered a cardiac arrest after the disorderly failure of Lehman Brothers in mid-September, raising legitimate questions regarding the depth and duration of the underlying breakage.

Third, we were aware that recent events extended the de-leveraging dynamics into a broader phenomenon with longer-term consequences. What Bill Gross called the DDR – the combination of de-leveraging, de-globalisation and re-regulation – inevitably disrupts the normal functioning of markets and the global economy.

Think of these three factors as constituting a strong blow to the gut of virtually every economy. Most are still on the floor trying to regain their breath.

## Secular Forum

May 2009

The major intellectual and analytical challenge for our Secular Forum was to figure out how the process of “getting up off the floor” would evolve over the secular horizon. Would it be simultaneous or sequential? Would those managing to get up pull others up with them, or would they push them down farther? And how long would it take for those able to get up to stand up straight again?

**Q: With such a rattling set of starting conditions, what is the very big picture prognosis for the global economy?**

**EI-Erian:** The world is travelling on a bumpy road to a new destination – or what PIMCO has labelled the “new normal.” Given the growing evidence, this concept is increasingly resonating in policy circles and among market practitioners.

Our analysis suggests that the recent abrupt changes to markets, households, institutions and government policies are unlikely to be reversed in the next few years. Global growth will be subdued for a while and unemployment will remain high. A heavy hand of government will be evident in several sectors. The banking system will be a shadow of its former self. The core of the global system will be less cohesive and, with the magnet of the Anglo-Saxon model in retreat, finance will no longer be accorded a preeminent role in post-industrial economies. Moreover, the balance of risk will tilt over time toward higher sovereign risk, growing inflationary expectations and stagflation.

**Q: The policy responses we’ve seen, both in the US and around the world, have been enormous by all measures. Have these been justified and will they be effective in staving off an even worse outcome?**

**EI-Erian:** If it had been left to its own devices, the global economy would have gone through an even more wrenching cleansing process. Unemployment would be spiking even higher, additional institutions would be failing and larger market segments, nationally and internationally, would be dysfunctional.

No democratically elected government is able to stand on the sideline when its electorate faces a situation where there is large and mounting damage to human welfare. This explains the host of bold and unconventional actions that are evident in the US, UK, China, Euroland and beyond.

However, in the process, such unconventional responses, by definition, are uncertain in their effectiveness yet consequential in disrupting some long-standing relationships. Think of this as the economic equivalent of a drug trial being applied to huge populations. There is a case for the medicine, yet there also remains considerable uncertainty about effectiveness, lags and side effects.

**Q: Since your debate was about the longer-term secular outlook, what did you determine will be the lasting effects, both from the breakdown of the system and the unprecedented government action?**

**EI-Erian:** The world has changed in a manner that is unlikely to be reversed over the next few years. Put another way, markets are recovering from a shock that goes way, way beyond a cyclical flesh wound.

It is not just about the major realignment of the financial system and the extent to which governments have intervened to offset market failures. And it goes beyond the massive increase in government deficits and government debt in virtually every systemically important

## Secular Forum

May 2009

country in the world. It's also about the structural change in how savings are mobilised and allocated, nationally and across borders. It's about the shifting balance between the public and private sectors. Additionally, we won't soon forget the long-lasting consequences of the erosion of trust in such basic parameters of a market system as the sanctity of contracts and property rights, the rule of law, and the robustness of the capital structure. Such trust can be lost quickly but takes a long time to restore.

The result is a prolonged pause, or in some cases, a violent reversal in certain concepts that markets had taken for granted. We referred to it as the demise of the "great age" of private leverage, asset- and credit-based entitlements, self-regulation, policy moderation, and shrinking direct government involvement. Not surprisingly given the extent of the gains that were privatised and the losses that are now being socialised, the demise is occurring in the context of popular anger, confusion and what one of our speakers called "a morality play" in halls of government around the world.

This is not to say that the global economy has no defences. We talked earlier about the massive policy response. In addition, the secular forces of productivity gains and entrepreneurial dynamism will not disappear. And there are pockets of considerable economic and social flexibility, high self-insurance and even some global policy coordination.

Yet, while these factors help reduce the risk of a deflationary depression, they are not strong enough for a return to the high growth and low inflation that characterised 2002 – 2007. Simply put, there are insufficient demand buffers and fast-acting structural reforms to provide for a spontaneous and sustainable recovery in the global economy.

### **Q: Can you give a more granular view into PIMCO's secular outlook?**

**EI-Erian:** Sure. For the next three to five years we expect a world of muted growth, in the context of a continuing shift away from the G-3 and toward the systemically important emerging economies, led by China. It is a world where the public sector overstays as a provider of goods that belong in the private sector. It is also a world in which central banks and treasuries will find it difficult to smoothly undo some of the recent emergency steps. This is particularly consequential in countries, such as the UK and US, where many short-term policy imperatives materially conflict with medium-term ones.

The banking system will be a shadow of its former self. With regulation more expansive in form and reach, the sector will be de-risked, de-leveraged and subject to greater burden sharing. The forces of consolidation and shrinkage will spread beyond banks, affecting a host of non-bank financial institutions as well as the investment management industry.

### **Q: What about the inflation outlook?**

**EI-Erian:** For now, it is hard to project any imminent pickup in inflation given the severity of the collapse in global demand and the resulting large output gap. Private components of global demand will not recover quickly and fully. Yet one should not fixate just on demand when transitioning from a cyclical to a secular mindset. Supply also matters.

Over the next few years, the historical pace of growth in potential output will face many headwinds, including excessive regulation, higher taxation and government intervention. All of these factors can constrain the growth of potential (non-inflationary) output.

## Secular Forum

May 2009

There is another interesting question here: Will the massive amount of fiscal and monetary stimulus adopted by the US authorities erode confidence in the public goods that the country provides to the rest of the world? We are talking here about the dollar as the world's reserve currency, and the tradition of deep and predictable US financial markets to intermediate the world's excess savings. An erosion of this would adversely affect inflation dynamics in the new normal.

### **Q: Can you say more about that last factor?**

**EI-Erian:** In its weakened state, the US can ill afford a reduction in the privileges ("implicit rents" if you like) that come with the provision of the public goods that support the dollar's reserve-currency status. The issue goes beyond the inflation dynamics. If it is not careful, the US could lose some control over its economic and financial destiny, thereby slowly and gradually assuming more of the characteristics of what economists label as "small open economies."

This is a fundamentally unattractive possibility – not only for the US but also for most other countries. None of them (let alone regions and multilateral bodies) is able and willing to assume the responsibilities at the centre of the global system.

### **Q: Going around the world, how does the secular outlook apply to the world's major regions?**

**EI-Erian:** The power of the convergence magnet – that mystical Anglo-Saxon model of liberalisation and de-regulation where a prosperous post-industrialisation phase relies on an ever-booming financial system – has weakened. No other model is able to step in at this stage. Accordingly, the partial vacuum will translate into greater country differentiation relative to what has taken place in the recent past.

In the developed world, we expect to see generally slow growth relative to the potential that we saw in the earlier part of this decade, but with varied scenarios in each region.

In the US, financial rehabilitation will happen in the context of low growth and a view toward an eventual inflationary bias. The UK will also be stuck in a low-growth world, but with greater vulnerability to domestic and/or external financial instability. In the European Union, growth will be hampered by a historical inflation phobia and concerns for the integrity of the EU itself. Meanwhile, Japan will also continue to face growth headwinds as its economy is too encumbered by fiscal and demographic issues.

Emerging economies will remain the global growth drivers, but we expect them to bifurcate more clearly into two groups. Those with weak initial conditions will return to the old emerging market paradigm that alternates between austerity and financial instability, while those with strong initial conditions will maintain their development breakout phase, albeit not at the torrid pace of recent years.

### **Q: What are the major risks to your forecasts?**

**EI-Erian:** Over the secular horizon, the combination of low global growth, inflationary influences, government policies and muted animal spirits in the market gives rise to a "balance of risk" picture that, unfortunately, is tilted to the downside.

## Secular Forum

May 2009

First, politics matter a great deal. Over the next few months, political feasibility (rather than economic desirability) will dictate several policy responses. Given the fragility of the global system, the world can ill afford policy mistakes and political unpredictability. Farther down the road, political commitment will be needed to drain the system of emergency liquidity.

Second, the healthy functioning of markets (and societies at large) depends on a set of implicit contracts. As is often the case in emergency situations, these contracts are being subjected to major shocks. The longer it takes to restore normalcy, the higher the risk of recurrent financial instability.

Third, the management of public debt in industrial countries will be a delicate process. For sure, the numbers going forward are very, very large – in terms of both stocks and flows – and the starting debt dynamics are not great.

Fourth, any further erosion in the autonomy and mission of key economic institutions, such as the Federal Reserve, would not help. Governments must resist the temptation to co-opt such institutions further, saddling them with fiscal activities that lack sufficient transparency and that rightly belong within the budgetary process.

Fifth, even our muted projections for global growth assume some important handoffs that are inherently difficult and face large time-inconsistency challenges. Remember, we are postulating that continued robust growth by some major emerging countries (particularly Brazil, China and India) to partially offset the lower growth in the G-3 and the UK, but this is premised on a significant pickup in the consumption of an expanding middle class in the emerging economies.

### **Q: What are the investment implications of PIMCO's secular outlook?**

**EI-Erian:** As always, the Forum process yielded a rich menu of strategic insights, starting with secular investment positioning and extending into product design, client servicing and business management.

With regard to our secular investment guardrails, our baseline favours the front end of yield curves in many countries as the authorities overstay with negative real policy rates. Additionally, we believe income-generating instruments will dominate in many cases the pure equity premium when it comes to risk-adjusted returns, and an international orientation is favourable because the US is facing the prospects of a plateau shift in sovereign risk and the return of higher inflationary expectations.

Over the next weeks, our specialist desks around the world will be working on assessing the implications of these factors for specific strategies, asset classes and products.

**Thanks, Mohamed.**

**Secular Forum**

May 2009

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