

Cyclical Outlook

October 2009

Andrew Balls on PIMCO's European Cyclical Outlook and Strategy



Andrew Balls

Mr. Balls is a managing director in the London office, a member of the Investment Committee and head of European portfolio management. (He leads PIMCO's European investment team, which is based in London and Munich, and manages European and global portfolios.) Mr. Balls was previously a global portfolio manager in Newport Beach and the firm's global strategist. He holds a bachelor's degree from Oxford and a master's degree from Harvard University. He was a lecturer in economics at Keble College, Oxford.

In this interview, Andrew Balls explains why PIMCO remains concerned about the sustainability of the recent recovery. In addition, the managing director and head of European portfolio management explains the firm's current investment strategy from a European investor's point of view.

Q: PIMCO's investment professionals recently gathered for the Cyclical Forum to discuss the firm's global economic outlook and investment strategy over a 6–12 month horizon. Given the recent signs of economic recovery, did you raise the forecasts on growth rates for 2009 and 2010?

Balls: We have seen stabilization in global financial markets since the Cyclical Forum in March. Global policy efforts have been successful in staving off the risk of global depression. We have revised our global forecasts slightly upward and now look for GDP growth of 0.5%–1.5% over the next 12 months for both the U.K. and the Eurozone. In the U.S., we expect GDP to grow between 1.0% and 2.0%. However, a significant part of this is the result of strong growth in the third and fourth quarters of 2009, the result of the massive policy responses and the turn in the inventory cycle. We remain concerned about underlying private demand growth and cautious on the outlook for 2010 and beyond.

Q: Does that mean you doubt the sustainability of this recovery over a longer horizon?

Balls: The forces of deleveraging, reregulation and de-globalization contribute to a secular outlook in which we expect growth to be weaker in the next three to five years than in the period leading up to the financial crisis. We are coming out of a very deep recession, the deepest recession globally in the post–World War II period, and a series of very large shocks have hit the global economy. The good news is that public sector interventions have stabilized the system and helped avert a global “Armageddon” risk. But we do not think this is going to be the V-shaped recovery that has been typical of post-war recessions.

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Regional Cyclical Forecast

	Real GDP		Inflation [†]	
	Current*	Q4 09 – Q3 10	Current*	Q4 09 – Q3 10
United States	-3.9%	1.0% – 2.0%	1.6%	0.25% – 1.25%
Europe	-4.7%	0.5% – 1.5%	-0.6%	1.0% – 2.0%
United Kingdom	-5.6%	0.5% – 1.5%	1.8%	1.0% – 2.0%
Japan	-6.4%	-0.5% – 0.5%	-1.7%	-1.5% – -0.5%
China	7.9%	8.5% – 9.5%	-1.3%	1.5% – 2.5%

Source: PIMCO

* For U.S., GDP and inflation as of 06/30/2009. For Europe and U.K. GDP as of 06/30/2009 and inflation as of 07/31/2009. For Japan and China, GDP as of 06/30/2009 and inflation as of 09/30/2009.

† U.S. inflation is Core PCE. (Note: Core PCE is usually about 50 basis points lower than Core CPI.)

Q: So that means PIMCO's secular outlook for a New Normal remains in place?

Balls: The secular framework remains in place, and we interpret the cyclical developments within that framework. At this time, we need to focus on stocks and not flows, or as Mervyn King, the Governor of the Bank of England (BoE), has said, to focus on levels, and not on growth rates. We have seen very large shocks to the global economy, and we have seen stabilization, but there are a number of areas in which we are concerned that we still need to see stock adjustments. The first is the still-high level of consumer indebtedness, particularly in English-speaking countries, and the need for ongoing increases in savings rates. The second area of concern is the need for ongoing adjustments in the financial sector; banks that still want to reduce leverage will not react to the upturn in the cyclical indicators with an increase in lending because they are still looking to reduce the size of their balance sheets. Third, and related, given the great amount of slack in economies around the world, is concern about the strength of private business investment. Finally, very high levels of unemployment around the world, together with weak income growth, reinforce the dynamic on the consumer side. With weak income growth, it is harder for consumers to delever their balance sheets.

There is an important distinction here with emerging market countries, where in many cases we have seen impressive rebounds, helped by large fiscal stimulus packages and aggressive monetary easing and better initial conditions in many cases. We believe that countries that are driven more by domestic demand – including Brazil and India – will continue to be among the best performers. In China, fiscal stimulus has been especially

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large to compensate for a decline in exports, and in particular a surge in infrastructure investment helped to get GDP back toward the 8%-type growth rate that the country targets.

Q: What is the reason for your concern about 2010?

Balls: It's concern about sustainable sources of cyclical private demand growth, consumption and private sector investment in the context of this difficult secular adjustment that we have described. In response to the great financial crisis, we saw a very large expansion of the public sector balance sheet, as the private sector households and businesses delevered. Our Co-CIO Bill Gross has referred to this as the first stage of a rocket to recovery. The second stage, which is firing now, is the turn of the inventory cycle, and this helps to explain the public sector balance sheet expansion and the stronger growth we anticipate for the second half of this year. However, for an expansion to be strong and sustainable, a third stage in the recovery rocket needs to fire, and that is private sector demand growth. And given ongoing pressure to delever in the household and financial sectors, less stimulus from public sector interventions as we move into 2010, excess capacity, high unemployment and weak income growth, we are concerned that the third stage rocket is not going to fire enough to support a robust recovery.

Take the example of the two sectors that traditionally drive economic recoveries. The housing sector is interest rate sensitive but in this cycle, in the U.S. and U.K. and some European peripheral countries, it was the core of the problem. Activity has stabilized at low levels, but it is hard to imagine any rapid turnaround. The auto sector is also interest rate sensitive and a traditional driver of recovery. But this time around, various cash for clunker schemes helped to support consumer spending during the downturn, but have borrowed from future activity. Our concern is that we will see more disappointing growth in 2010, weaker growth than the market consensus anticipates.

Q: What are the major differences between the European and U.S. economies?

Balls: The main difference we see between the Eurozone and the U.S. is the stronger initial conditions in the core Eurozone countries, which we typically describe as Germany, France and the Netherlands. These countries experienced very sharp slowdowns as financial markets froze and, particularly in Germany's case, as global trade collapsed. But overall, we see less exposure to the financial leverage cycle and some greater stability in their economies. We do not anticipate very robust growth in the Eurozone as a whole, and remain concerned about demographic issues and weakness in some of the other Eurozone members. Still, given the size of the core countries, we see overall greater stability and less downside risk or double-dip risk in 2010 compared with the U.S. or U.K. In peripheral European countries, there are more negative outlooks and difficult adjustments that must be made over time, and in some cases, worse initial conditions. Just as Germany had to make a difficult adjustment within the Eurozone earlier in the decade, now a number of peripheral countries have to make difficult adjustments to

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increase competitiveness, given that the old option of exchange rate depreciation is not available to them.

The U.K. shares more of the characteristics of the U.S. in terms of the exposure to the financial leverage cycle, household leverage and the need for rebuilding of savings, and greater question marks over the withdrawal of support from stimulus and risks to the economy in 2010. The difference between the U.K. and the U.S. is that the U.K. is a small, open economy; the U.S. is a larger, more closed economy. In the U.K.'s case, the depreciation of the currency holds the potential for a bigger improvement in exports, although to date the impact has not been all that impressive. On the negative side, as a small, open economy without the benefit of America's reserve currency status, there is a greater risk that the adjustment in sterling could become disorderly, posing very difficult trade-offs for the BoE.

Q: Inflation is currently subdued in the Eurozone and U.K. Do you expect consumer prices to stay stable for the time being, or do you expect inflation to rise?

Balls: Looking over the next 12 months, we see very subdued inflation in the Eurozone and subdued inflation in the U.K. The European Central Bank (ECB) has been relatively relaxed about deflation as the result of a lower oil price, but there is of course the risk that deflationary expectations do become entrenched. Inflation has remained stickier in the U.K. compared with the U.S. or the Eurozone, in large part reflecting the impact of the weaker currency. In the baseline case, the very wide output gap means that there is very little reason to worry the diminished sterling could increase inflation risks. Unless the pound weakens substantially further, we expect, over time, the impact of the output gap in the U.K. to push inflation lower.

Around the world, over a one-year cyclical outlook, we see very little inflation pressure in the system, owing to the wide output gaps globally. Looking beyond the cyclical horizon, the outlook is hard to judge, with both inflation and deflation risks – one of the examples of the difficult secular journey we must navigate in the New Normal. There are deflation risks over time, if lower inflation becomes entrenched. At the same time, there is the risk of higher inflation, owing to the extent of public policy interventions and the difficulty of timely removal of these interventions. It adds up to a more volatile outlook over a secular period, with deflation risk in the nearer term, and higher inflation risk further out.

Q: Is this the right time for European investors to buy inflation protection?

Balls: The decision to implement an inflation-linked strategy is always linked to an investor's overall asset allocation and liability decisions, but in generalist portfolios, we do not think that now is the time to be overweight in inflation-protected securities because of our below-consensus views on growth and inflation. However, over the secular outlook, we think that inflation-hedging strategies will be important, including inflation-linked bonds.

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Q: Can you describe the major strategic changes emerging from the Cyclical Forum?

Balls: Overall we're cautious, reflecting our views about the rally and risks to recovery scenarios. While partly justified by stabilization in the system, the markets may have gone too far too fast in anticipating a robust recovery in 2010. We remain overweight duration in our portfolios, and broadly neutral in terms of curve exposure. We've also reduced corporate spread in our portfolios, reflecting our concerns about the near-term outlook. Within credit, we retain the position of being overweight financials versus underweight industrials. In the industrial sector, spreads have tightened close to their pre-Lehman Brothers levels, while we still see elevated and attractive spreads in high-quality financials. Overall, we plan to maintain a high-quality bias in our portfolios, and an emphasis on investments that we expect to generate steady income over investments relying more on hopeful capital gains and more leverage to economic recovery. We remain cautious on high yield investments, given our macroeconomic outlook.

Q: How are you positioning your portfolios in emerging markets?

Balls: We are very positive on high-quality emerging market (EM) exposures over the secular outlook, during which we expect stronger growth overall in EM countries compared with more sluggish growth in the Organization for Economic Co-operation and Development (OECD) countries. We plan to maintain overweights in select EM currencies, based on this secular view. But otherwise, at a time when risk assets have rallied sharply, we remain fairly cautious on other EM exposures outside of dedicated EM strategies.

Q: What is your strategy when it comes to currencies?

Balls: As mentioned, the core view remains the overweight in high-quality EM currencies, notably Asian emerging market countries, where we expect exchange rate adjustment and liberalization to contribute to the rebalancing of that part of the world toward more domestic-led growth over the coming years. We plan to remain underweight the U.S. dollar and the British pound, where weaker exchange rates are required as part of the adjustment toward manufacturing production and away from over-reliance on the consumer sector to support growth. Elsewhere in the G-10, we are not expressing strong views on currencies. The euro may continue to benefit from global diversification away from the U.S. dollar. Against that, on standard valuation metrics it looks expensive.

Q: How are you positioning your total return portfolios along yield curves?

Balls: We have moved to be broadly neutral on curve, while maintaining duration overweights. The first reason is that we now see very steep curves around the world, and we feel that the potential gains at the front ends of curves are much more limited compared with the period of 2007 and 2008 and the first half of 2009. We continue to see the front ends of curves as very attractive in terms of the carry we can earn, particularly in the U.S. and the U.K. and to a lesser extent in the Eurozone. But there is little room for rates to fall substantially. Given our outlook for weaker growth than the consensus view and very little inflation risk over the next year, we think that we could see more gains in the five-year and 10-year part of the curve and further out, particularly if the market starts to price in greater deflation risk.

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Q: There has been much ado about policymakers' exit strategies: When do you expect European central banks to start withdrawing from emergency mode, and when will they finally start raising interest rates?

Balls: We still see interest rate hikes as a long way off, in Europe and elsewhere. Over time, we expect central banks to pull back on the unorthodox policies that they have instituted over the past year to 18 months. But for now, recent central bank statements indicate the focus remains on the need to support the recovery and on the downside risks to the recovery, rather than pre-emptive moves to exit from policy interventions. Over time, of course, central banks will exit from their policy interventions, and we have seen some differentiation here between the U.S., which has signaled that quantitative easing will end and its mortgage purchase program will end, and the U.K., which has signaled that it will continue with quantitative easing. It will be important to anticipate the exit from policy interventions, and particularly the sequencing of exits within a country and across countries, but over the cyclical outlook, we think the market prices stand too much in the way of rate hikes for the ECB, the BoE and the Federal Reserve.

Thank you, Andrew.

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