



P I M C O Secular Outlook

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A New Normal

PIMCO believes that secular economic, social and political trends exert the most powerful and sustained influences on bond markets. We define "secular" as the next three to five years. Our secular outlook guides the way we structure portfolios in terms of duration, yield curve positioning, sector exposure, credit quality and other risk measures. It also informs our thinking for overall business management, client service and product development. PIMCO develops its secular view at our annual Secular Forum, during which our investment professionals from around the world gather in Newport Beach for three days of discussion and debate about the global economy and financial markets. We invite outside speakers – experts in economics, finance, history and politics – to supplement our internal analysis. The following are key conclusions from our 2009 Forum:

PIMCO believes that following the severe shocks to the global economy in the second half of 2008, the world embarked upon a journey of change not likely to be reversed over the next few years. This journey, likely characterized by starts, stops and volatility, will end at a destination or "New Normal," some of the features of which are outlined below:

Slow Growth in Developed Economies – Growth rates in developed economies are likely to be lower over the next three to five years. Potential growth in the U.S. could fall from 3 percent in the recent past to around 2 percent. One reason is debt exhaustion at the household level (especially in the U.S. and UK) and deleveraging among financial institutions that will make it difficult for the global economy to adjust as it has in prior economic crises.

Politics Matter – Another reason for muted growth will be a dampening of productivity as the public sector overstays as a provider of goods that belong in the private sector. More regulation and higher taxes will restrain the growth of output. While government involvement was clearly necessary to stabilize the financial system, the global economy is now highly vulnerable to policy mistakes. These could include protectionism, mismanagement of public finances and the overriding of investors' contract rights.

Emerging Economies to Bifurcate – In general, emerging economies should grow faster than the developed world. There will be a continuing shift in the balance of economic power away from the major developed economies and toward important emerging countries. Emerging economies will divide into two groups. Countries with fiscal and economic imbalances will return to the old paradigm that alternates between austerity and instability. Those in stronger financial condition and with growing internal markets, such as China, will maintain their development breakout phase, though not at the torrid pace of recent years.

Short Term Deflation, Long Term Inflation – Deflation risks should predominate in the near term given the severity of the collapse in global demand and the resulting large gap in actual versus potential output. Inflation risks will come to the fore later in the PIMCO secular horizon, however, as potential output becomes more constrained, in

part due to supply destruction, and policymakers struggle to withdraw the massive levels of monetary and fiscal stimulus that have recently been introduced.

U.S. Dollar Risk – In the U.S., inflation risk and currency risk are linked. Should U.S. policymakers lack the commitment or the skill to drain the system of emergency liquidity at the appropriate time, confidence in the U.S. dollar as the world's reserve currency could erode.

Banking and Finance to Shrink – The financial sector's formerly commanding presence in the economy will be curtailed. With regulation more expansive, the sector will be de-risked, de-levered and subject to greater burden sharing by politicians. Consolidation will spread beyond banks to non-bank financial institutions and the investment management industry.

INVESTMENT IMPLICATIONS

Favor the Front End of Yield Curves – Yields on short maturities are likely to be anchored near current low levels for a longer period than what is now priced into forward interest rate curves. Policymakers in many countries are likely to overstay with loose monetary policy.

Emphasize Income-producing Instruments – An environment of low growth and political uncertainty favors high-quality, yield-oriented securities over those offering mainly capital gains. With regard to credit risk, it will make sense to stay relatively high up in capital structures, as yield premiums and valuations of equities and subordinated securities will reflect heightened risks of burden sharing and contract disruptions.

Focus on Global Securities – Diversification outside the U.S. will likely yield benefits. U.S. bonds, especially Treasuries, will face greater sovereign risk as the U.S. debt burden mounts and inflation expectations start to rise later in our secular time frame.

Hedge Against a Weaker U.S. Dollar – Investors should look to protect themselves against the risk that U.S. policymakers will not be able to prevent erosion in the value of the dollar. The magnitude of the dollar's depreciation against other currencies could be outpaced by the dollar's fall against real assets.

WHAT THE EXPERTS SAY

PIMCO taps the best minds in economics, finance, politics and history to help formulate our Secular Outlook. We invited four outside speakers to this year's Secular Forum. Here is a summary of what they had to say.

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FAREED ZAKARIA

Best-selling author, editor of Newsweek International and host of Fareed Zakaria GPS on CNN

Zakaria argued that the current economic crisis is a product of success rather than failure. He described himself as an optimist in the current global economic crisis and noted that the speed and scale of the response by governments has been striking. He contended that policy makers are aggressively attacking the economic crisis because the cost of over-reacting could be much less than the cost of under-reacting. His optimism about the global situation is attributable to his belief that the American economy is incredibly resourceful. For example, the U.S. has labor mobility while Europe and Japan do not have enough workers. He acknowledged risks to his thesis, chief among them that the U.S. may not be able to make difficult political decisions to reduce government spending and tighten monetary policy when the crisis is over. Politicians seem to have lost the ability to inflict short-term pain for longer term gain. Zakaria emphasized the need for global cooperation in a world where the global economy is so complex and fast moving that nobody fully understands it.

PROFESSOR WILLEM BUIETER

Professor of European Political Economy at the European Institute of the London School of Economics and Political Science; former member of the Bank of England's Monetary Policy Committee and Chief Economist of the European Bank for Reconstruction and Development

Buiter's focus was on the future of capitalism. Before the current crisis erupted nothing of this magnitude had been imagined. There have been dozens of financial crises in both the 20th and 21st centuries, which are not uncommon within a capitalist-based economy. Financial crises are protracted affairs, with asset market collapses becoming deep and prolonged, coupled with profound declines in output and employment and rapid increases in government debt. Today's industrial country financial crisis has all the symptoms of the emerging market (EM) crises of the last few decades, but the main differences are the U.S. currency's reserve status and the size and global contamination of the crisis. Buiter argued that the contraction will last at least until the end of 2010 to early 2011, which will be followed by

a bout of inflation in the U.S. and possibly U.K., but not likely in Euroland. Growth will return to the advanced industrial countries and in EM, but will be slower than during the years 1999-2007.

HON PETER COSTELLO MP

Australia's longest-serving Treasurer (1996-2007); Deputy Leader of the Liberal Party

Costello addressed how global policy makers view the current crisis and provided a recommendation for the appropriate response: uniform, international regulations to be implemented and enforced by a single national regulator within each country. Costello dismissed the idea of the International Monetary Fund (IMF) or another international body becoming an effective global regulator of financial markets. He argued that the IMF is ill-equipped to prevent financial crises due to inadequate funding; insufficient knowledge of local financial markets; and unwillingness by many countries to cede authority to the IMF. As for dealing with future asset bubbles, he dismissed the idea that central banks must take responsibility. He stressed that finance ministries have more levers to unwind asset bubbles in an orderly way, particularly by using taxes in coordination with the central bank. Costello warned against over-regulation and voiced concern that the level of global fiscal stimulus would lead to higher taxes and inflation, increased currency volatility and redistribution of economic power from the developed nations to emerging market nations, particularly China.

DR. WILLIAM WHITE

Former Economic Adviser and Head of the Monetary and Economics Department, Bank for International Settlements

White presented two major themes in his argument that the global financial crisis will not be resolved until well after the PIMCO secular horizon has past. First, he argued that we have seen this all before in terms of the causes and implications of the crisis. Second, he maintained that we have endured a solvency crisis, as opposed to a liquidity crisis. The implication is that structural damage to the system has been much deeper than most believe. White stressed that avoiding another bubble will require coordinated and pre-emptive monetary and fiscal policy. He also suggested that a global organization focused solely on systemic risk is necessary to prevent future crises.

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