

Cyclical Forum

December 2006

Paul McCulley Discusses PIMCO's Cyclical Outlook and Investment Strategy



Paul A. McCulley

Managing Director, Portfolio Manager

Mr. McCulley is a Managing Director, generalist portfolio manager, member of the investment committee and head of PIMCO's Short-Term Desk. He also leads PIMCO's Cyclical Economic Forum and is author of the monthly research publication *Fed Focus*. Mr. McCulley joined PIMCO in 1999, previously serving as Chief Economist for the Americas for UBS Warburg. During 1996-98, he was named to six seats on the Institutional Investor All-America Fixed Income Research team. He has twenty-two years of investment experience and holds a bachelor's degree from Grinnell College and an MBA from Columbia University Graduate School of Business.

PIMCO Managing Director Paul McCulley leads the firm's quarterly Cyclical Economic Forums, in which our investment professionals from around the world gather to discuss the outlook for the global economy and financial markets over the next 12 months. In the following interview, Mr. McCulley discusses the results of the December Forum and its implications for PIMCO's investment strategy.

Q: PIMCO held its latest Cyclical Economic Forum in early December. What were the key issues to discuss in updating the firm's cyclical outlook?

McCulley: The issues we explored at the December Forum were very similar to those we discussed at the last Cyclical Forum in September. The key question is still how nasty the slowdown in the U.S. housing market will become, in both volume and pricing terms. And from there, several other key questions follow. How nasty will the spillover effects of a nasty housing market be on non-housing economic activity and growth in the U.S., notably in consumption? And how contagious will nastiness in the U.S. be for non-U.S. growth? How quickly and how deeply will inflation respond to a U.S.-led global growth deceleration, and how will central banks react? And finally, what are the wildcards in the outlook? Those were the key questions heading into the December Forum.

Q: How would you characterize PIMCO's overall conclusion from the Forum? Is a soft landing still the most likely outlook for the global economy?

McCulley: We continue to look for a global soft landing, with decoupling of growth across regions and with generalized, modest disinflation. In contrast to the divergence in growth, we are looking for convergence in global monetary policy as the Fed reverses to easing and the rest of the world's central banks bring tightening campaigns to a close and then go on protracted hold, even if they don't join the Fed in reversing policy.

In terms of the numbers, we continued to lower our forecast for U.S. GDP growth, which we now see ranging from 1.75% to 2.25% over the next 12 months, which is down from our September forecast of 2% to 2.5%. We also trimmed our core inflation forecast for the U.S., with the range now 2% to 2.5% versus 2.25% to 2.75% in September. We raised our forecast for Europe, where we now expect real GDP growth

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to range from 1.75% to 2.25%, up from our September forecast of 1.5% to 2%. But, as with the U.S., we lowered our core inflation forecast, putting the range at 1.5% to 2% versus 1.75% to 2.25% in September. For Japan, we left our growth forecast unchanged at 1.75% to 2.25% for real GDP but again trimmed our core inflation forecast to a range of 0% to 0.5%, down from 0.25% to 0.75% in September.

Q: Let's start with the U.S. housing market. Why does the housing market play such a key role in the overall outlook for the U.S?

McCulley: We all know there is a link between the housing market and consumption, so we spent much of our time at the December Forum debating how tight that link is. The latest data we reviewed at the Forum confirms that the housing sector recession is every bit as nasty as we thought it would be in terms of volume of sales, volume of inventory and pricing. However, at the same time, job destruction in the sector, and in related sectors, has been very limited to date. Indeed, if there has been one major surprise since our September Forum, it has been the strength of employment growth, pulling the unemployment rate below 4.5%.

We believe part of the employment strength is simply due to the lagging nature of construction employment versus housing permits and housing starts. Builders have to complete their existing stock of housing starts before the job destruction associated with plummeting new housing permits, and housing starts, kicks in. That lag kicked in with the October employment data, with payrolls falling by 25,000, and we sense that we have a long way to go before the employment data fully reflect the job destruction in the housing-related sectors.

The lag effect in employment also helps to inform our view on the likely magnitude of the spillover from housing to economic activity more generally, notably consumption growth. To date, consumers seem to be aware that their homes aren't appreciating as quickly as in recent years. But with job creation remaining sturdy, consumption has moderated only modestly, at least in the quarterly data. Here again, lags are in play, as most recent monthly data, notably for retail sales, show decided sequential slowing. And, most important, the ISM Purchasing Managers Index has now fallen below 50, indicating contraction in the manufacturing sector and signalling that housing's woes, in tandem with the auto manufacturers' difficulties, are no longer isolated to a few sectors, but are generating weakness at the macro level.

So, the bottom line on the U.S. is that we notched down our growth forecast just a touch. But the larger question of just how nasty the spillover from the recession in housing (and to a lesser extent autos) will be remains an open, debatable proposition. Our baseline forecast calls for a soft landing in the U.S., but the risks are asymmetrically tilted toward a harder landing.

Q: Turning to the global outlook, what did PIMCO conclude regarding the spillover effects that a U.S. slowdown could have on Asian growth?

McCulley: Simply put, U.S. demand provides a huge amount of stimulus for China and China provides a huge amount of stimulus for the rest of the Asian region. The China

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juggernaut has powerful momentum, but at the margin, the most recent data suggest a very modest deceleration—nothing major, but it does appear that policymakers' restrictive administrative tools are having an effect at the margin. But those effects are only being felt at the margin because the investment boom in China continues.

The multiplier effect of U.S. and Chinese growth is nowhere more clear than in Japan, which is a huge and growing exporter of capital goods to China. To be sure, some of China's investment boom is no doubt excessive, which is why Chinese authorities are trying to temper it. But as long as China keeps on keeping on, the rest of the region will, too, absorbing America's soft landing more or less in stride. So we do see some decoupling between U.S. growth and Asian growth.

Q: Is European growth also decoupling from the U.S.? PIMCO raised its European GDP forecast while lowering the forecast for U.S. GDP.

McCulley: The European economy feels like it is booming, though we need to remember that Europe really is a low-volatility region when it comes to growth. In Europe, 2.5% growth is seen as robust while growth of 1.5% leads to gnashing of teeth. The reason European growth is near the top of that zone right now is sturdy business confidence. Capital spending, notably in Germany but also elsewhere in Europe, is very robust as companies strive to compete globally, investing in efficiency- and productivity-enhancing plans.

At the same time, European companies are also stepping up the pace of investment in human resources, with job growth walking on much stronger legs. Despite the job growth, wage growth remains very much in check. Labour in Europe has very limited pricing power, as Eastern European immigration and the threat of outsourcing to the East remain powerful, secular disinflationary forces.

Thus, while more people are being employed, boosting payrolls, growth in aggregate real earnings per worker remains very subdued, boosting corporate profits and limiting the upside for consumer spending growth. In addition, property markets—at least outside of the U.K. market—are coming off the boil, portending less strength from that source, as well as more tempered growth in credit and the money stock.

And, of course, German citizens will face a large, 3-percentage point increase in their VAT [value-added tax] come January, which will undoubtedly temper expenditure growth for large-ticket durable goods. Some of those big-ticket purchases have presumably been brought forward into this year, giving the economy an unsustainable glow.

In contrast, the U.K. economy keeps motoring along, riding on the back of London—Europe's leading financial centre and thus the prime beneficiary of growth in the financial sector—and the London property market, in particular.

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Q: From a strategy perspective, how are PIMCO's global growth expectations affecting the firm's view of what the Fed, European Central Bank and Bank of Japan will do regarding interest rates?

McCulley: If our U.S. growth and inflation forecasts come right, in the context of the ISM index now south of 50, our Fed call is a higher-confidence call: further tightening is simply verboten, and easing, not standing pat, becomes the odds-on proposition. Recall, ISM never goes south of 50 without triggering a reversal to easing!

In Asia, the Bank of Japan really does want to continue normalizing monetary policy after the very adroitly handled exit from quantitative easing and the zero interest rate policy. But the Bank of Japan's freedom to raise rates is severely limited by very tame domestic inflation, the global growth risks coming from the U.S., and the likelihood that the yen will be very sturdy.

The European Central Bank is not happy and is seeking even tamer credit and money growth, while worrying about the direct inflation effect of Germany's VAT hike. Accordingly, we fully expect the ECB to continue preaching a sermon of inflation vigilance, acting on it up until the point the Fed starts easing and/or the Euro reaches uncomfortable heights. In contrast to the ECB, however, the Bank of England is less populated with inflation hawks and is manifestly more likely to follow the Fed's lead, or at a minimum, not go in the other direction.

Thus, while there is a global growth decoupling story in our forecast, there is much less of one in our monetary policy forecast. Once the Fed turns to easing, any further tightening elsewhere becomes a very long-odds proposition.

Q: And how is the firm's latest cyclical outlook influencing investment strategy?

McCulley: It remains a risk management world, both for global central bankers and PIMCO. While global soft landing is the baseline outlook, the predominant alternative is a harder landing, led by the United States, in particular the U.S. consumer losing their hedonistic mojo. That doesn't happen very often, as it's never a good idea to bet against the U.S. consumer for very long. But the U.S. consumer has never been so broadly levered to an overvalued asset like the U.S. property market, which has many bubble tendencies. We shall see.

Q: Thank you, Paul. We look forward to talking with you again after PIMCO's next Cyclical Forum in March.

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Singapore

PIMCO Asia Pte Ltd
30 Cecil Street #23-01
Prudential Tower
Singapore 049712
65-6491-8000
Registration No. 199804652K

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The ISM Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment.

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