

Spotlight

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Scott Mather Discusses PIMCO's Secular Outlook for Europe



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Mr. Mather is a Managing Director, and a senior member of PIMCO's portfolio management and strategy groups. He is head of Portfolio Management in Munich (Deutscher Investment-Trust Gesellschaft für Wertpapieranlagen mbH) where he manages euro and pan-European portfolios and oversees portfolio management teams based in Munich (DIT). In addition, he works closely with many Allianz related companies and is a Managing Director of DIT. Previously, he co-headed PIMCO's mortgage and ABS team and managed portfolios of European Supranationals and U.S. Agencies. Mr. Mather joined PIMCO in 1998, previously having been associated with Goldman Sachs in New York, where he was a fixed income trader specializing in a broad range of mortgage backed securities. He has eleven years of investment experience and holds both a bachelor's and master's degree in engineering from the University of Pennsylvania, as well as a bachelor's degree in Finance from The Wharton School of the University of Pennsylvania.

Each year, more than 100 of PIMCO's investment professionals from around the world gather for the firm's Secular Forum, a three-day discussion of the outlook for the global economy and financial markets over the next three to five years. Following PIMCO's most recent Secular Forum in May, we spoke to Scott Mather, head of portfolio management in Munich, about the firm's secular outlook and investment strategy for Europe.

Q: PIMCO held its latest Secular Forum in May to discuss the outlook for the next three to five years. How has the firm's secular outlook evolved since last year?

Mather: One of the key conclusions from the 2005 Secular Forum is that the risks to global economic stability are increasing. The balance of risks has tilted away from an inflationary endgame and towards a greater risk of disinflation/deflation. Despite some of the fastest years of global growth in decades, energy price spikes, and one of the easiest and most enduring periods of expansionary monetary and fiscal policy on a global scale that the world has ever witnessed, core inflation remains well contained and is falling in many important economies. This speaks to the power of some of the disinflationary forces at work in the current global system. Rapid globalization of tradable goods and services is removing inflationary bottlenecks, increasing labor competition and creating capacity surpluses that outstrip demand in many areas of the economy.

Economic policy, in the hands of relatively few policymakers, is the glue that holds the current system together. In 2004, we coined the term "stable disequilibrium" in recognition of the fact that ultimately the imbalances must be corrected, but that policy decisions can allow the imbalances to persist or even grow for extended periods before the final destabilization point. Our outlook remains focused on the development of the policy responses to these instabilities, the likely timing of the unwind and the most likely consequences of the current system's demise.

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In 2004, we concluded that the world was becoming increasingly unbalanced in terms of growth and commensurate capital flows by almost every metric. These imbalances meant that the distribution of outcomes was anything but “normal”. Instead, the distribution of economic outcomes resembled a “fat-tailed” distribution. We likened our central scenario for the economy to that of a tightrope walker balancing between inflationary “fire” on one side, and deflationary “ice” on the other. Both outcomes would have dramatic and unpleasant consequences with different implications for the bond market.

These imbalances have not been resolved and the risks to global economic stability have increased. Some of the imbalances are being temporarily masked by a reflationary cocktail consisting of massive amounts of monetary stimulus and fiscal deficit spending delivered on a global scale. This, coupled with a system of managed currencies that we and others have dubbed “Bretton Woods II”, is the policy “glue” holding together the current economic system.

Bretton Woods II can best be described as an informal currency agreement in which the U.S. dollar serves as the reference currency to which most Asian currencies are de-facto pegged. While not a formal arrangement, the system works because all participants have a vested interest in preserving the status quo, even though it accommodates further growth in economic imbalances.

China (and the rest of Asia) continues to experience rapid growth and large investments, as it is able to industrialize and employ hundreds of millions of willing workers. This rapidly raises living standards and brings political stability. Similar to the rapid Japanese industrialization of the 1960’s and 1970’s, this mercantilist economic behavior depends heavily on the health of export markets. The de-facto currency peg to the U.S. dollar assures export competitiveness and growth in dollar reserves. The dollar reserves are then recycled back into the global economy, primarily through investments in dollar-denominated fixed income instruments. In return, the global consumer benefits from lower-priced imports and from lower interest rates than would otherwise be the case.

While it would appear that the world’s most competitive producer (China) and the world’s most voracious consumer (the U.S.) would be the most self-interested parties in the arrangement, Europe has much at stake as well. For Europe, the current arrangement serves to boost global demand, which, without the U.S. and China, would be sorely lacking given the dearth of internal aggregate demand in Europe. In addition, the euro, as a global reserve currency that is allowed to freely float and the only competitor to the U.S. dollar, has suffered a real appreciation versus both the U.S. and much of Asia. This too exerts a disinflationary bias in Europe.

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Q: How significant is the risk of deflation in Europe?

Mather: We anticipate that inflation will fall further in Europe over our secular horizon, raising the possibility that much of Europe is forced to deal with the consequences of disinflation and possibly even deflation. Europe is faced with serious deflationary headwinds over our secular horizon. Some of these disinflationary forces are brought about by internal forces: increasing economic, monetary, and political integration and enlargement. Secular trends of deregulation, market harmonization, social reforms and labor competition are slowly eroding inflationary propensities. These structural reforms are also increasing political unrest and eroding business and consumer confidence, which further limits the ability of the Eurozone economy to grow above potential and generate inflationary offsets.

In addition, a more rapidly aging European population will continue to exert deflationary pressures as household formation continues to retreat, and even turn negative in many European countries. Other disinflationary biases are externally imposed via the Bretton Woods II arrangement. Because Europe acts as a buffer for what, in our view, must be an inevitable decline in the value of the dollar, the euro is likely to remain overvalued relative to where it would be without Bretton Woods II. This continues to put downward pressure on import prices in euro-land and acts as a drag on monetary conditions, thereby slowing growth and reducing inflationary pressures.

Q: Despite the increased risks of a breakdown in Bretton Woods II, PIMCO's base case forecast is that the arrangement will endure for the time being. What are the implications for Europe if Bretton Woods II remains in place?

Mather: Europe will likely muddle along with sub-standard growth in an environment of declining inflation. Acting mostly as an outsider looking into Bretton Woods II, Europe doesn't reap all the benefits the Bretton Woods II participants garner. Europe benefits from Bretton Woods II via the increased external demand from the two big world growth engines, the U.S. and China. But the upward pressure imposed on the euro by the Bretton Woods II arrangement offsets this external stimulus. This is particularly troublesome because a very large portion of the growth that the major euro zone economies have experienced since EMU has come from net exports. Unfortunately, the pace of structural reforms in Europe is not able to keep pace with the pressures of rapid globalization. Europe's labor market faces the prospect of becoming less and less competitive in the global marketplace.

Q: What are the prospects for domestic demand in Europe over the secular timeframe?

Mather: There simply hasn't been any glimmer of domestic demand taking root and it is increasingly obvious that the hand-off that was supposed to occur in the euro zone, from net exports to investment spending and domestic consumer demand, just isn't happening. Going forward, it is also unlikely that this hand-off is going to happen because the European consumer is not getting the same stimulus from the Bretton Woods II arrangement as the U.S. consumer.

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Europe doesn't get the same amount of artificially low interest rates as the U.S. because the majority of the capital flows that need to be reinvested from Asia are going into U.S. dollar instead of euro zone assets. Real rates are still very low in Europe, that's true, but the economy doesn't have the same responsiveness to interest rates as you see in the U.S. because of the different structure of the mortgage market, consumer finances, and a different propensity to consume.

In addition, European companies and employees are facing increasing competition from the integration of new eastern and central European members. This is further acting to reduce investment within the core countries and is further depressing the situation of labor, which is forced to cope with declining rates of real wage growth. Furthermore, the already comparatively large tax burden that euro zone companies and consumers are forced to bear in support of the welfare state looks likely to increase over the secular horizon. This will further dent the prospects for a recovery in domestic demand.

It seems likely that the threat of structural reforms will continue to deter demand at a faster rate than the actually implemented reforms are able to unleash. The pace of reforms is stalling at a critical juncture. This is especially true now that European policymakers are likely to be further distracted by the breakdown of their major policy initiatives. The last couple of years have witnessed the unraveling of very important cornerstones of European reform with the breakdown of the Stability and Growth Pact, the Services Initiative, and more recently, with the rejection of the European constitution in France and the Netherlands.

Q: Considering these concerns about the lack of domestic demand in Europe and the level of the euro, does PIMCO expect a European recession over the next three to five years?

Mather: Our secular forecast calls for growth in the euro zone of 1.0% to 1.5%, which is well below the equilibrium rate of growth that keeps the economy edging towards full employment. Virtually half of the euro zone economy is teetering on the verge of recession at this moment. The odds of the entire zone shifting into a full-blown recession in our secular horizon have certainly increased. The developments in external demand are likely to dictate whether an official recession is encountered or not. But regardless, many countries within the euro zone will experience a recession and, given the deteriorating employment situation, it is likely that it will feel like a recession even in those countries that are able to avoid the technical definition of a recession.

Q: How is the political situation in Europe affecting the economic outlook over the secular timeframe?

Mather: There will be increased political turmoil within Europe over the next few years. Governments in Germany, France, and Italy that had a large measure of popularity a few years ago are crumbling and are at all-time lows in terms of popularity. This is not surprising given the complete failure of Continental Europe's social market economy to

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provide employment. Unfortunately, this unpopularity is causing some governments to shy away from reform, and even leading some political parties to contemplate exiting the monetary union, rather than confront the problems. This will only intensify now that economic prospects and employment conditions are deteriorating. The political turmoil will act to increase uncertainty and further dampen business and consumer confidence. The ensuing slowdown in economic reforms will further damage the long-term growth prospects of most European countries. Fiscal constraints imposed by what remains of the Stability and Growth Pact, along with practical political limits, will mean that there is little chance for counter-cyclical fiscal policy. At the same time, the one-size-fits-all monetary policy imposed by the ECB [European Central Bank] will increase economic pressures and divergences within the euro zone over the secular horizon.

Q: Turning to investment strategy, what are the investment implications of PIMCO's secular outlook for Europe?

Mather: We will position ourselves to take advantage of low and falling inflation. That means taking a position further out the yield curve in order to take advantage of falling inflation expectations and risk premiums. In addition, the demand for duration will increase further from aging populations in Europe.

A continuation of Bretton Woods II implies that demand for high-quality government bonds will remain very robust as savings from surplus countries continue to accumulate and are recycled into high-quality sovereign bonds. It also implies a range-bound market in which there will be opportunities to profit from volatility within the range.

Q: PIMCO spent a significant amount of time at this year's Secular Forum discussing pension issues and the potential effect on demand for long-term bonds. Would you elaborate on the firm's conclusions as to how this would affect the European market?

Mather: One of the biggest differences between Europe and the U.S. is that there is a less-well-developed private pension system in Europe. Only a very small private pension market exists in most European countries. In addition, the dominant public pay-as-you-go schemes in Europe are in more dire straights than the U.S. Social Security system because European societies are older and are retiring earlier than in the U.S. The European economy is also growing more slowly than the U.S. and is therefore less able to support the generous benefits that have been promised from the system. Europe's public pension crisis will therefore unfold much sooner than it will in the U.S.

Many of the private pension schemes that are operating within Europe tend to be small and many of them suffer the same under-funding problems we have in the U.S. In addition, the majority of the private schemes in Europe are running large mismatches between the duration of their assets and liabilities. This will need to be addressed in coming years by the addition of longer duration bonds. The need for longer duration assets to match liabilities will increase with falling rates.

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For Europe, an issue that is perhaps even more important than the pension issue is the need of insurance companies to match assets and liabilities. In the absence of well-developed private pension schemes, life insurance products remain a favored savings vehicle for old age. So the life insurance industry is very large in Europe and growing quite rapidly. Most insurance companies have traditionally profited by running asset-liability mismatches and having significant weightings in equities. But falling rates and declining prospects for above-average equity returns are increasingly putting pressure on companies to address the mismatch between longer-duration liabilities whose value increases faster than the value of the assets in a low-rate environment. In addition, there are accounting and regulatory changes being implemented in most countries to shore up the practices and creditworthiness of insurance companies. This too will increase demand for long-duration, high-quality assets in Europe.

Q: What is PIMCO's outlook for short-term bonds? Will the potential for a recession in the euro zone prompt the ECB to lower short-term rates?

Mather: The ECB has kept their policy rate unchanged for over two years. But given our forecast for a decline in inflation and growth over the secular horizon, we believe the most likely next move by the ECB will be a cut in rates. However, the ECB cannot be described as an activist monetary institution. For several reasons, they have a very steady hand with respect to policy changes. The ECB is not like the Federal Reserve in that they do not have a dual objective, as the Fed does. The ECB has no employment objective. Instead, it targets inflation only.

The ECB won't be moved very easily by falling growth and tough employment conditions. Instead, it will focus on inflation and money growth, both of which have been running slightly above their target since the inception of the ECB. Because of this past "failure", and setting aside the issue of whether this is in fact the right policy objective, the ECB believes there is a "monetary overhang" which must gradually be removed in order for them to maintain credibility with respect to their stated objective. On this front, the ECB has been true to its mission and, given our outlook, the ECB now runs the risk of continuing to fight the war on inflation well past the point of victory, on through to disinflation and potentially deflation.

Therefore, we expect short-term rates to be less volatile than in the past with a bias to the downside. This should provide short-term bonds with very good risk-adjusted returns in the years ahead.

Q: Within Europe, does PIMCO favor bonds from any specific countries over those issued in other countries in the euro zone?

Mather: Our expectation is for more differentiation between countries within Europe. The scope for more political turmoil within Europe and more variation in economic performance means there will be more differentiation between countries. There are already tremendous differences in fiscal and debt dynamics at the sovereign level among European countries.

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The breakdown of the Stability and Growth Pact, which was designed to impose a universal fiscal discipline across Europe, will likely mean that it will be left to market participants to discipline the fiscal “sinners” through higher risk premiums. In addition, the stresses of public old-age spending from the rapidly changing demographics will impact some countries much more severely than others.

In large part, we feel that most market participants have been ignoring the fundamental differences between countries. This has led to unnaturally tight spread compression and very little differentiation between countries. We expect this to change over the secular horizon and we will tilt our portfolios towards the highest quality core countries like Germany and France, especially at the long end of the curve where differentiation should be far greater.

Q: Thank you.

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