

Cyclical Outlook

January 2009

Paul McCulley Discusses PIMCO's Cyclical Economic Outlook and Investment Strategy



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Mr. McCulley is a managing director, generalist portfolio manager, and member of the investment committee in the Newport Beach office. In addition, he heads PIMCO's short-term bond desk, leads PIMCO's cyclical economic forums and is author of the monthly research publication, Global Central Bank Focus. Prior to joining PIMCO in 1999, he was chief economist for the Americas at UBS Warburg. During 1996-98, he was named to six seats on the Institutional Investor All-America fixed-income research team. He has 25 years of investment experience and holds an MBA from Columbia Business School. He received his undergraduate degree from Grinnell College.

PIMCO Managing Director Paul McCulley leads the firm's quarterly Cyclical Economic Forums, where 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 PIMCO's economic and market outlook for 2009.

Q: With US and many global economies now squarely in a recession, how has the economic debate shifted at PIMCO?

McCulley: When formulating our outlook, we typically fine tune our GDP and inflation forecasts as a means to anticipate changes in central bank policy. But for now, the standard fine tuning has been put on the shelf because the reality of a recession brings clarity to forecasting. Tracking macroeconomic variables becomes less important than understanding global themes, so we're no longer muddled in a debate over hard landings or soft landings.

A recession also brings clarity to policy responses, which will continue to address risks associated with deleveraging at the institutional level as well as the potential for further sharp reductions in personal consumption. In the US, the Fed Funds rate is now essentially at zero and traditional monetary policy is no longer a key issue for economic forecasters. Our new focus is on what the Fed and other central banks are doing with their balance sheets and to what extent governments are working to substitute sovereign credit for the broken system of private sector credit creation.

So our job is to look at a policy response that falls between creeping socialism and galloping socialism. There might be varying personal philosophical arguments about where on the creeping-galloping scale it is, but you can't argue with the fact that it's socialism.

How will we fund this socialism? Well, it's important to note, and the crisis has reminded us of this, we live in a US-centric world. One major reason is the huge US consumer base. But equally important is the fact that the US dollar is the global reserve currency, and there is a natural global demand for our sovereign's liabilities. If there is any question about that, just look at what the US dollar has done over the last few months. So we won't necessarily have a big problem funding socialism.

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Q: At what point does PIMCO's forecast see policy responses taking hold and fostering an economic recovery?

McCulley: We're convinced that there is enough will among policy makers to do whatever it takes for a necessary and sufficient policy response, both domestically and internationally. The responses aim to deal with the dual maladies of the "paradox of deleveraging," which dictates that widespread and simultaneous deleveraging will drive down asset prices and lead to further deleveraging, and the "paradox of thrift," which tells us that if everyone attempts to save at the same time, they will actually drive down the overall rate of savings. When the private sector intermediation plumbing has clogged up, then the sovereign has the duty to be the Roto-Rooter of last resort. That is being accomplished with the central bank's balance sheet, the fiscal balance sheet, and joint ventures both domestically and internationally.

But these processes take time. In 2009, we expect a continued recession as the sovereign balance sheet takes on the risks that the private sector's balance sheet won't. This will put a floor under private sector asset prices and restore some degree of functionality to intermediation between private sector savers and private sector borrowers. But this will not dramatically change the economic fundamentals over the next 12 months.

The first signs that policy is gaining traction will likely be a revival of risk appetites in financial and asset markets. To date, valuations have fallen to compelling levels from a fundamental standpoint, largely due to forced selling by over-levered investors, yet the private sector is still not willing to take on risk. PIMCO expects we will not be past the most severe damage to the auto, finance and housing sectors until 2010, and only then will we begin to see full effects of the policy responses.

Q: What is PIMCO's baseline cyclical forecast for the next 6 to 12 months and what are the primary risks to this forecast?

McCulley: Massive global deleveraging has driven developed economies into one of the most severe recessions since World War II, and our baseline forecast for 2009 is a continuation of that gloomy scenario.

Destruction of demand and wealth has created large and growing excess capacity. This output gap will fuel disinflation and may even create deflation for a time. While the Fed has injected huge levels of liquidity into the financial system, transmission of these reserves out into the broader economy has been constrained by the strong demand for cash among financial institutions and consumers. This cash hoarding should keep inflation subdued over a cyclical timeframe.

Economic conditions should improve in 2010 as policy responses in the US and abroad gain traction. As I mentioned, a recovery of risk appetites in financial markets will be the leading indicator for recovery in the broader economy. The risks to that baseline scenario are clearly to the downside, but while a global depression is possible, it is not probable as policymakers will exercise all realistic options to avoid it.

For 2009, I'll let the forecast numbers determined at our recent Cyclical Forum speak for themselves. Looking ahead to 2010, after lengthy discussion at the forum, most of us, with a few honourable exceptions, took the view that policy responses would be partially successful and the economy was likely to muddle through at the macro level. However, when Forum participants were forced to vote for either a scenario of policy traction and reflation or a scenario of policy failure and ongoing global recession with risk of a depression, the split was two-thirds to one-third in favour of the former.

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PIMCO's 2009 Economic Forecasts

| Forecas | Real GDP | | Inflation* | |
|----------------|----------|----------------|------------|----------------|
| | Current | Q1 – Q4 2009 | Current | Q1 – Q4 2009 |
| North America | 0.8% | -1.75 – -2.25% | 2.45% | 0.5 – 1.0% |
| Europe | 0.65% | -0.5 – -1.0% | 3.2% | 1.25 – 1.75% |
| United Kingdom | 0.3% | -1.5 – -2.0% | 4.5% | 1.0 – 1.50% |
| Japan | -0.1% | -1.25 – -1.75% | 2.3% | -0.25 – -0.75% |
| China | 9.0% | 8.7 – 9.25% | 4.0% | 1.75 – 2.25% |

*US inflation is Core PCE. (Note: Core PCE is usually about 50 bps lower than Core CPI).

Q: With much of the world seemingly in a recession, is the notion of a global economic “decoupling” from the US valid any more?

McCulley: A year ago, there was a notion that the global decoupling thesis was going to be a bridge to a better place. But the bridge wasn't a bridge, it was a pier, and the decoupling thesis has walked right off the end.

The developed world – particularly Europe, the UK and Japan – are likely to be mired in recession over the next year. In the Eurozone, investment and exports were the main drivers of recent growth, but final demand in Europe has not been insulated from the global credit crunch. The UK is even more vulnerable than Europe due to higher levels of consumer debt and the huge real estate correction driven by a US-like mortgage meltdown. The crisis has hit Japan through a sharp drop in the stock market and a rally in the yen, which is hurting its exports. With external demand the only potential growth engine, Japan's economy is highly correlated with the rest of the world, and should remain in recession through 2009.

Q: What about Emerging Markets? They have also felt the impact of the global crisis, but does the longer-term decoupling thesis hold?

McCulley: Emerging markets are definitely feeling the pain. The paradox of thrift applies at the global level as well as the national level. If American households want to save more, then someone else needs to save less, or global market stabilisation is going to occur at a level of global GDP that many will find uncomfortable. The problem of global reliance on US consumer demand has not been addressed during close to seven fat years.

Major emerging economies such as Brazil, Mexico, Russia and India are facing strong headwinds. While exports to developed countries are not expected to contract, they are expected to slow, and on top of that, EM credit markets have also become restrictive.

Longer term, the theory of the decoupling of emerging markets from the US and other developed markets remains as viable as ever. Emerging economies became the primary contributors to global expansion over the last several years, as their share of global GDP growth surged to more than half the total, and we expect this trend to

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continue, especially because many EM countries had maintained much stronger fiscal positions going into this crisis.

In China, weaker external demand is helping to cool the rapid expansion of recent years. Nevertheless, the government's plans for massive fiscal stimulus signal that Chinese policymakers will do whatever is needed to prop up domestic demand. Unlike developed economies, China's banking system no longer faces systemic risks due to a successful campaign to reduce problem loans over the last several years.

Q: What are the investment implications of the cyclical outlook?

McCulley: From the investment perspective, we are looking at things in terms of prevailing valuations. We have to ask ourselves where valuations currently are, relative to this "muddle along" scenario, and also consider the "tail" situations, where the economy sinks into depression or a situation where policy works exceedingly well and the recovery is sooner and stronger than we currently envision.

The corporate bond market and various areas of the asset-backed market are currently priced for depression-level cumulative defaults. However, these valuations do not reflect a true belief a depression is inevitable as much as they reflect the massive deleveraging that has taken place in the bond markets. Asset prices are where they are because the marking clerk came in and said, "Son, lose the position." That's not a fundamental decision, that's a flow of funds phenomena.

We are resolutely of the belief that investment opportunities in 2009 are going to be about credit spread duration, not just interest rate duration. With rates already considerably lower, the money to be made in betting on interest duration has already been made. We're more concerned with deciding which bond market sectors we want to be engaged with, and we're most interested in spread product that has explicit and implicit support from a sovereign. If the government is going to lever up, risk up and gear up to get the private sector intermediation process working, then we want to piggy back on that trade.

We want to own cars that run on socialist gasoline – the sectors that will unambiguously be the beneficiaries of a reflationary thrust from policy – particularly when you can get them at incredibly wide spreads to pure interest rate products. Not surprisingly, we're favoring debt securities and hybrid securities of the banks that are being supported on three fronts 1) TARP money in the form of equity investments 2) FDIC guarantees on unsecured debt and 3) access to the Fed's liquidity facility. These opportunities are global, because governments around the world are stepping up to support the key banks in their countries.

Q: Thank you Paul.

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