

Spotlight

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Paul McCulley Discusses PIMCO's Cyclical Outlook and Investment Strategy



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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 September Forum and its implications for PIMCO's investment strategy.

Q: Before we get into the details of PIMCO's latest cyclical outlook, would you give us some background on how the economic environment has changed since the firm's last Cyclical Economic Forum in March?

McCulley: What's changed is that the level of uncertainty has gone up dramatically. That uncertainty has been turbocharged by Hurricane Katrina, but even before the storm we've had two things going on since our March Forum that were raising the level of uncertainty in the economic outlook

Number one is the U.S. housing market and the Federal Reserve's reaction to the housing market; and number two is that energy prices have gone up dramatically relative to six months ago. Those two forces have been operating in opposite directions, which tends to create uncertainty because you have forces coming at you that have totally opposite effects.

The housing market has clearly been a major source of the household sector's ability to continue spending at a clip that has arithmetically driven the savings rate to zero, despite very weak growth in real earnings per hour. We've been seeing decent growth in earnings in aggregate because we've been seeing decent growth in jobs, and aggregate earnings are a function of aggregate jobs. But when you dig deeper, real earnings per hour of work have not been growing strongly at all.

The reason consumers have been able to spend robustly while struggling under weak growth in real wages per hour is that they've been able to turn their houses in an ATM machine, as we've said many times around here. So you've had the property market providing a source of strength but at the same time you've had rising energy prices acting as a drag.

Spotlight

October 2005

And then, with those two competing influences to figure out, we've had the Fed come in this summer and say that they were worried about the property market being overvalued and implicitly saying that they would tighten more than otherwise would be the case in order to take the starch out of the property market.

So, as we were going into the September Forum, there was a whiff of stagflation in the air, particularly when you look farther out on the horizon. If we assume that the property market comes off the boil, then what's left is a consumer that doesn't have the tailwind of the property market but rather a headwind of his or her energy bill, which gives you the "stag" in stagflation—and, then, the arithmetic impact of energy prices gives you the 'flation.

Q: How has Hurricane Katrina affected the economic environment? Has the storm increased the potential for stagflation?

McCulley: When Hurricane Katrina hit, it upped the ante on the risk of stagflation and the risk that higher energy prices dramatically weaken the consumer's ability to spend. The most extreme worries have faded in the last couple of weeks as gasoline prices have come back down to pre-storm levels, but they're still up dramatically on the year.

Looking out on the horizon, the biggest issue right now is that natural gas prices and winter heating bills are probably going to be up 30% versus last year. And for a good chunk of the country, that matters even more than the price of filling up the SUV. So, Katrina gives us more concern on the growth side, but also more concerns on the inflation side, because of the increase in energy prices.

We also know we're going to get a rebuilding effort and a lot of fiscal spending in the wake of this tragedy. In part, that will simply replace income generation in the private sector that was lost due to the storm, but it also will be a stimulus to aggregate demand. Because, remember, in the way we account for our economic growth, wealth destruction doesn't subtract from GDP because wealth is a stock and GDP is a flow, but wealth rebuilding does add to GDP.

There's an old joke that the easiest way to boost GDP growth is to break all the windows in all of the houses in America and then replace them, because destructing the windows is not a minus but replacing the windows is a plus. It's not a policy that I would recommend, but that is the arithmetic, if you will, of how tragedies of this nature enter into the national accounting.

Q: With this backdrop of rising uncertainty and the potential for stagflation going into the Cyclical Forum, what did PIMCO conclude about the outlook for the next six to 12 months?

McCulley: As a group, we marked down our growth forecast and marked up our inflation forecast, which is precisely what you would anticipate that we would do in the face of an oil price shock, because that's what an oil price shock does. For an oil-

Spotlight

October 2005

importing country such as the United States, it's a negative for growth and also a negative for inflation.

I guess you could say that we projected a "stagflationary soft landing," if that's not a contradiction in terms—and I don't think it is. The outlook is stagflationary, but the outlook is for a soft landing of a stagflationary character as opposed to a stagflationary recession, which is what happened after the oil price shocks in 1973 and 1979.

Q: How does the potential for a "stagflationary soft landing" affect the outlook for Fed policy?

McCulley: With regards to the Fed, the first question is how high they will need to take the Fed Funds rate to get at the property market. And the second is how long this will take, because when we think in terms of a cyclical outlook, timing is hugely important. You know that if the Fed wants to pop a bubble, they can pop a bubble. But the issue is the timing and magnitude of the monetary response that is necessary to produce that outcome.

Following Hurricane Katrina, I think you have to reduce your trajectory for Fed funds relative to what your trajectory was before this tragedy. That may not be terribly helpful because people want to know what the number is, but I think Bill Gross's comments captured it best when he said we're near the end of the Fed's rate hiking cycle. As a group, we think that a stagflationary soft landing implies about 4% or so, plus or minus a little bit, as the stopping point in the Fed's rate hiking campaign.

Post-Katrina, the market had been pricing in 4% as the stopping point as well, but following the September rate hike to 3.75%, the market is back to assuming that the Fed will continue to march the Fed Funds rate upwards. The Fed is searching for the magical neutral rate that will slow the economy without shutting it down, which is why they've been moving in 25 basis point increments. We simply think the neutral rate is 4%, and this is where we differ from the market. There are some of us, myself particularly, who would be on the optimistic side of that issue and believe that the Fed could very well be finished before we get to 4%.

Q: Does PIMCO believe a 4% Fed Funds rate will be enough to significantly slow the housing market?

McCulley: For the housing market, our base case scenario is that year-over-year changes in median home prices are going to slow from double-digit increases in the neighborhood of 12% down to mid-single digit increases, which would be a soft landing for housing at the national level.

At the same time, we believe there are a number of geographical areas in the real estate market that won't have a soft landing and could actually see price declines rather than just slower price appreciation. It's not a national bubble but there are more than a few pockets of bubbles around the country and they're unlikely to have soft landings.

Spotlight

October 2005

Spotting the turning point in housing is a critical issue in our outlook. Bill Gross appointed mortgage guru Scott Simon to lead an Investigative Team, as we call it, that is reporting back in virtually real-time to the Investment Committee on the state of the property market. So far, the Team has done on-the-ground work in 10 cities, including riding along with real estate agents and working with mortgage brokers, to give us a real-time pulse on when the turn in those regional markets is coming.

Q: When doing this on-the-ground research in various cities, what does PIMCO's team look for in terms of signs of a turning point in the local housing market?

McCulley: We look at three factors when we're trying to figure out when a local housing market is going to starting topping and then roll over.

One is an increase in the supply of homes on the marketplace as investors start trying to monetize their speculative gains. That really is where the bubble is. It's not in people buying a roof over their heads intending to have that roof over their own heads but rather in speculating on property. The second factor is listing time, or how quickly the inventory of houses is turning over. And the third factor is where realized prices come out relative to listing prices.

The classic sign of a market turning over is when inventory goes up, houses stay on the marketplace a lot longer before selling, and when a house sells, it sells below, and increasingly further below, the offering price, as opposed to at or above the offering price with multiple bids. So those are the three classic microeconomic signals in the property market that we literally have a real-time pulse on—thanks to Scottie and his Team.

Q: Turning to the market, how is PIMCO's updated cyclical outlook affecting the firm's investment strategy?

McCulley: In our Investment Committee meetings following the Forum, one of the things we kept reminding ourselves of is that our long-term secular outlook anchors investment strategy. And coming out of the Secular Forum in May, we had two simple propositions. The first is that Bretton Woods II, in which Asia and emerging markets finance the U.S. current account deficit and consumer spending by buying our bonds, has legs. And the second proposition is that the stimulative effect of fiscal and monetary policy—the “pumps,” as Bill Gross called them—is becoming less and less potent.

So in formulating our investment strategy, we reaffirmed our secular views, even though we acknowledge that fiscal spending in the wake of the destruction from Hurricane Katrina will provide some additional potency to the fiscal pump. We look at that not as a massive long-term pump but as a cyclical pump that in some respects is replacing income that was destroyed as opposed to being a huge net stimulus to economic activity.

Spotlight

October 2005

When we combine our secular forecast with a sense that the Fed is likely to stop at 4%, more or less, we decided to be modestly overweight on duration—not a lot but a little on the long side. With respect to curve strategy, we are modestly overweight in the front end of the curve.

The reason I say “modestly” in the case of both duration and curve positioning is that one of the overarching themes following our Cyclical Forum is that when uncertainty goes up, rational people moderate their risk-taking proclivities. Your risk-taking appetite should be directly proportional to your conviction on the outlook, and when uncertainty goes up, conviction levels go down. Therefore, risk-taking positions should be appropriately downsized.

Where we’re not modest is in the corporate sector, where we continue to be meaningfully underweight, reflecting the fact that the market is very richly priced considering the potential for a stagflationary soft landing. The risk/reward tradeoff for corporate bonds is decidedly negative. Given where existing spreads are, they can’t tighten much but they could widen a lot, and asymmetric payoffs are particularly unattractive in a world of increased uncertainty.

Q: On a secular basis, PIMCO has favored holding mortgage-backed securities as a strategy for selling volatility. How has the cyclical outlook affected the firm’s view on mortgage-backed securities and volatility sales?

McCulley: We expect to be moderately overweight in mortgages, reflecting our secular view that mortgages should benefit from the continuation of Bretton Woods II, which dampens volatility at the long end of the yield curve and therefore favors selling volatility. Mortgages are also very high quality bonds and we want to have high quality bonds in our portfolio.

On a cyclical basis, our overall volatility sales are going to be modest relative to where we’ve been in the past. Sometimes we sell volatility directly through options strategies, but we’re less likely to do that in an increasingly uncertain world.

Q: PIMCO has also had a long-term preference for holding emerging market bonds and inflation-indexed TIPS. Has the cyclical outlook prompted any change in the outlook for emerging markets or TIPS?

McCulley: We reaffirm our commitment to the emerging markets sector even while recognizing that the sector is not as attractively priced because it’s performed so beautifully well.

With respect to TIPS, we have materially reduced our positions in the last six months. A stagflationary soft landing favors front-end TIPS because of inflation accruals. But further out the curve, we don’t have a table-pounding viewpoint. And when you don’t have a table-pounding viewpoint, you shouldn’t have a table-pounding position. What we’ve done has been to pull back on our opportunistic allocation to the TIPS market.

Spotlight

October 2005

Q: Are there any sectors that PIMCO finds particularly attractive on a cyclical basis?

McCulley: One particular area of focus that looks attractive is the long end of the municipal bond market. It is very cheaply priced and we know that in the wake of Katrina, there is only one direction that tax rates can go, for the wealthy. And the wealthy obviously appreciate the tax benefits that municipals offer. So, to the extent that good opportunities present themselves, we may be increasing our exposure in long-dated municipal bonds.

Q: Is PIMCO still bearish on the U.S. dollar?

McCulley: We're still long-term bearish on the dollar, based upon the notion that there will be leakage from Bretton Woods II over time. Remember, Bretton Woods II, in addition to making interest rates lower than would otherwise be the case, also makes the dollar higher than otherwise would be the case. We expect to implement that view with modest currency positions quite similar to those we have right now. That includes a modest long position in the Japanese yen and a modest position in a basket of emerging market currencies. But we'd expect our non-dollar currency exposure to remain limited to no more than about a 2% overweight.

Q: If PIMCO favors the yen, what is the firm's view on Japanese Government Bonds?

McCulley: We think Japan is in a genuine recovery. That recovery is grounded in the boom that's going on in China, but it's real nonetheless. And we don't anticipate a hard landing but a soft landing for China, so Japan's recovery has legs. We're also anticipating that residual deflationary pressures in Japan will fade, leading to a small but positive inflation rate in Japan.

Based on that view, we think the Japanese Government Bond market is more likely to trade off than to rally, meaning that the risk in the Japan interest rate market is asymmetric. Therefore, in global portfolios, we will actually be modestly underweight, or short, Japan duration, reflecting the asymmetry from existing pricing as well as the Japanese recovery.

Q: And finally, does PIMCO believe Europe is also due for a stagflationary soft landing like the one expected for the U.S.?

McCulley: You can't call it a soft landing because Europe never rose to a level they can land from. I guess we'd characterize it as a stagflationary slow grind, with the most important implication being that the European Central Bank is on hold. Given that the stagnation in Europe is going to be exacerbated by the energy price issue, the ECB has no reason whatsoever to tighten policy. The most likely case is that the ECB does nothing, but there is a higher probability of easing rather than tightening, primarily because the core inflation rate is finally grinding down in Europe.

Spotlight

October 2005

For the United States portfolios, we've been overweight Europe and that's been a dominant contributor of alpha over the last year to our portfolios. We've had the position on average, which has worked, and we've traded the position well. But we also recognize that you don't get to go to heaven twice for the same good deed and the 10-year sector in Europe is now trading about 100 basis points below U.S. 10-year rates.

Our strongest conviction regarding Europe is that the Bank of England will nudge U.K. short-term rates down a bit more in 2006, so we have some overweight in the front end of the U.K. curve. We also like the risk/reward parameters in Sweden, which has a 1.5% short rate versus 2% for the European Union, and we don't envision any tightening out of the Riksbank in Sweden. So, therefore, the front end in Sweden and the U.K. would tend to be our best ideas in the European theater.

Q: Thank you, Paul.

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