

Spotlight

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Paul McCulley and Bill Powers Discuss PIMCO's Secular Outlook and Strategy



Paul A. McCulley
Managing Director



William C. Powers
Managing Director

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.

Mr. Powers is a Managing Director and a senior member of PIMCO's portfolio management and investment strategy groups. Mr. Powers oversees PIMCO's Rates, Global and Offshore portfolio management groups. He joined PIMCO in 1991, previously having been associated with Salomon Brothers, and with Bear Stearns as senior managing director, specializing in mortgage-backed securities. Mr. Powers has twenty-two years of investment experience, and holds a bachelor's degree in economics from Princeton University and an MBA from Stanford Graduate School of Business.

Forming PIMCO's Secular Outlook is a collaborative process in which more than 100 of the firm's investment professionals gather at our annual Secular Forum to discuss the three- to five-year outlook for the global economy and financial markets. Reflecting this collaborative approach, we asked two senior members of PIMCO's investment committee, Managing Directors Paul McCulley and Bill Powers, to answer some of the key questions about PIMCO's Secular Outlook and investment strategy.

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Q: What were the key conclusions from the Secular Forum?

McCulley: Our first key conclusion from this year's Secular Forum is that the informal global monetary accord between the U.S., China and the rest of the world, known as Bretton Woods II, will continue in the years immediately ahead. The global economy and financial system remain in what we have dubbed a "stable disequilibrium". Therefore, our base case scenario is that the global economy continues to muddle along and at various times resembles the "Goldilocks" economy—not too hot, not too cold.

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But we don't worry about the base case, we worry about the risk case scenario, which is that Bretton Woods II ends sooner rather than later. At this year's forum, we concluded that many of the risks are tilted toward an early end to Bretton Woods II, and that if Bretton Woods II does come to an early end, it would tend to exert a deflationary bias to the world rather than an inflationary bias.

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The bottom line is that our three- to five-year outlook for the 10-year Treasury is 3% to 4.5%. In the base case scenario, we'd probably be in the upper half of that range. But if it looks like this global monetary accord called Bretton Woods II is unraveling, then we would likely move to the bottom of that range as opposed to breaking out on the other side.

Q: What are the risks to a continuation of Bretton Woods II?

McCulley: The number one risk to Bretton Woods II is protectionism, notably in the United States. The U.S. consumer wins from the Bretton Woods II arrangement but the losers are those in the U.S. manufacturing sector who are being hollowed out by the cheap labour in China. And the manufacturers who are being hollowed out apply pressure in the political arena and politicians tend to respond to it because those who are being hollowed out by global competition tend to be single issue voters. In that context, we focused a lot on a bill circulating in Congress known as the Schumer-Graham bill which says that America will apply a 27.5 percent tariff across the board on all goods coming in from China if China doesn't revalue its currency within the next six months in a meaningful way. From the standpoint of economics, you couldn't think of a more silly idea, but it is a risk.

Risk number two is that Bretton Woods II endemically has bubbles associated with it. The United States has very low inflation because of the competition from the labour supply in the rest of the world and therefore you will systematically have easy monetary policy. Easy monetary policy creates liquidity and liquidity has a tendency to go into asset speculation including, most importantly in the current context, property markets around the world. So an early end to this arrangement could come from the bursting of the bubbles that are created by this arrangement, causing the system to come apart.

Risk number three is commodity prices. China's development combined with easy monetary policy in the United States has put tremendous upward pressure on commodity demand. Rising commodity prices actually don't hurt China all that much because they're at the early stage of development, but high commodity prices do hurt the United States because we're a very advanced economy. So the distorting effects on commodity prices relative to each of the players in the system would be the third source of concern we have regarding risks to an early end to this arrangement.

A fourth concern is geopolitical risk, because you have a system where the poor are lending to the rich. But the poor are becoming absolutely more rich themselves and effectively want to have seats at the global geopolitical table. Whether it be China with respect to Taiwan, or other Middle Eastern nations with respect to Iran, you can come up with a many potential geopolitical flashpoints that come to the forefront as the poor part of the world becomes richer and wants a seat at the table. Geopolitical uncertainty is not something we can forecast but something we should be very aware of, and is the fourth vector of concern on the risk side.

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And the fifth risk is that Euroland is the odd man out in this global monetary arrangement. They chose not to become part of the system and have paid the price from the standpoint of a deflationary shock with the appreciation of their currency. At the same time, they have had the deflationary shock of globalization and the opening up to Eastern Europe. So therefore the political solidarity of Europe raises questions as well about how long this Bretton Woods II arrangement can continue, because make no mistake, if the rest of the world is in a reflationary mode and Euroland opts out, then Euroland becomes the shock absorber in a disproportionate way because the euro is the only currency that can seriously move within the current global configuration.

Powers: Another risk in addition to the ones that Paul has already outlined is how much it costs China, Japan and other countries to inherit U.S. monetary policy through the Bretton Woods II arrangement. Right now, the cost for Japan and China is nothing. In fact, it's profitable. As Japan and China soak up the dollars that are flowing into their region by issuing domestic debt, the interest rates Japan and China are paying on domestic debt are far below the interest they are receiving on U.S. fixed income. But South Korea is right at the cusp of this arrangement starting to impose a cost on them and that is one of the reasons that South Korea appears to be front and centre in considering diversification away from U.S. fixed income.

Q: Considering the potential risks to Bretton Woods II, why did PIMCO conclude that the arrangement will continue over most of the three- to five-year secular timeframe?

McCulley: America clearly gets a huge amount of benefit from the Bretton Woods II arrangement. As the designated hedonist in this arrangement, the U.S. gets to live beyond its means and living beyond your means is a rather pleasurable thing to do. The rest of the world, and particularly China, wins as well because U.S. consumption provides a customer for them. This is particularly important for China as they move their people from state-owned enterprises into private-sector enterprises that must pass the test of the global marketplace. So China wins from the standpoint of redirecting its physical labour resources to more productive, profitable pursuits. China also wins because as a result of its growing reserves, it's able to attract foreign direct investment that is profit-driven and capitalist-driven. So China is on this journey to effectively employ its resources as well as its huge savings in a capitalist fashion and they are benefited by being connected to the United States in this endeavour, and then the rest of the world falls in line.

Powers: Another factor that should support the continuation of Bretton Woods II is that the risks no longer appear tilted toward higher inflation. When we looked at Bretton Woods II a year ago, one of the key risks was that, in a reflationary world, if inflation was on its way past 3% on its way to 4% percent, then China and Japan might pause in their purchases of U.S. fixed income. If inflation in the U.S. migrated to China, creating bubbles or higher and undesired inflation, then they would have to deal with that policy issue. But, as Paul mentioned, one of the big changes in our forecast is that we no longer believe that the risks are tilted toward higher inflation.

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Q: Why have the risks tilted from higher inflation to disinflation?

Powers: A year ago, we believed that a combination of monetary policy stimulus, fiscal stimulus and the potential for a weaker dollar suggested the risks were tilted toward deflation. We observed that in the post-bubble, post-September 11 period, with the Fed funds rate going from 6% to 1%, and the U.S. budget going from a 2% surplus to a 5% deficit, the most inflation that stimulus could create was a little more than 3%. Today, these potentially reflationary factors are all on the wane.

In examining this issue at this year’s forum, we concluded that reflationary policies have served as a “pump” that has inflated asset prices but with limited capacity to do so in the future. The best example of the effects of this asset pump is in five-year TIPS [Treasury Inflation Protected Securities]. In 2004, real rates on five-year TIPS were 4%. That 4% rate is now 1%. You don’t have to be a math major to figure out that we are 75% of the way toward 0% real rates and there can’t be much more to go.

The drop in real rates from 4% to 1% produced a 14% price increase in five-year TIPS, which has shown up in other asset categories. This drop in real rates has been seen on a levered basis in the price of homes, and homeowners have extracted equity from their homes to fuel consumption. Paul has coined the term that I think is the best description, which is that Americans have used their homes as an ATM.

Today, we observe that this fiscal policy is reversing. The Bush administration has pledged to cut the deficit in half over the next four years. Few would agree that it is either possible or desirable to halve this deficit in either 2006 or 2007. The deficit reduction will occur at the back end of Bush’s term, if at all. But we know that the trend is for less fiscal stimulus. That is going to impose a cost on growth.

Second, monetary policy has already become less stimulative, with the Fed funds rate rising from 1% to now 3%, and we will likely get one more rate hike to 3.25%. We have seen, on the margin, monetary stimulus taken away and fiscal stimulus taken away.

Third, we still believe the dollar is in a long-term bear trend, but recently the increasing value of the dollar has created the third element of tightening.

As effects of past stimulus moderate (probably after the next 12 months), we expect the CPI to come down from 3%. But looking out into our three- to five-year secular horizon, we think it’s going to be very difficult to get 3% inflation. We think we are going to see 2% inflation, maybe as early as the second half of 2006. Longer term, in the back end of our secular horizon, we expect to see the return of 1% CPI growth.

Q: Does PIMCO expect a recession either in the U.S. or globally over the secular timeframe?

Powers: No. The U.S. consumer will continue to borrow money and spend. As Paul mentioned, U.S. consumers are hedonists. Hedonists will spend as long as someone

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lends them money. We also expect only limited contributions from the corporate sector (certainly subpar relative to prior expansions). The risk to the modest growth with price stability scenario is no longer that the U.S. economy will overheat, but that U.S. growth will be less than expected. That could combine with a slowdown in China, where recent 10% growth will likely come down towards 6%-7%. That has externalities for the emerging market countries, who are exporting commodities, not the least of which is oil.

We’re not calling for a recession in the emerging markets or a hard landing in China. We’re simply saying that these growth dynamics that have been hot recently are due to moderate through our secular horizon.

Q: Where does productivity enter into the equation for corporate America and U.S. economic growth?

McCulley: Corporate profit margins as a share of GDP in America are at the highest level in 30 years, so the corporate sector really has been reaping the benefits of strong productivity as well as reaping the benefits of incredibly low real interest rates and, up until the last year, a steep yield curve. So effectively, the corporate sector has had two huge tailwinds of an accommodative financial environment and a very docile workforce but a very productive workforce.

Over time, labour will get some of the fruits of its productivity, which implies that corporate profit margins as a share of GDP are not going to be going up and any logical sort of reverting to the mean would suggest that corporations are moving into a headwind period after having enjoyed a tailwind period.

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Powers: Productivity was given credit for the U.S. economic performance in the expansion, but it’s our belief that this could be more of a finance-based phenomenon than a productivity-led miracle. So, an out-of-consensus view by PIMCO is betting against this durable productivity miracle and simply saying that as this stimulus disappears, you’re unlikely to maintain 4% GDP growth. That’s how we arrive at our secular growth forecast, which is incidentally unchanged versus a year ago. We’re still calling for 2% to 2.5%. When you add 1% productivity with 1% population growth, without any mystery, you arrive at a 2% number.

Q: Turning to investment strategy, how does PIMCO expect changes in the secular outlook to affect the bond market?

Powers: We start by observing the potential for disinflation to replace inflation over our secular horizon. Trends and initiatives in pensions and the demographics of aging in the developed world imply higher savings. In addition, we observe the limited composition of duration available for the market to purchase. The outcome is the risk in the bond market—that there is too little, rather than too much, high quality duration available.

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As pension funds and insurance companies begin to realize that we are in a lower inflation world, we believe they are more likely to take some duration risk off the table rather than maintain the current mismatch between their assets and liabilities. In plain English, relative to their liabilities, pension funds and insurance companies do not own enough long duration bonds in a disinflationary world. The Treasury has announced its desire to reissue long debt. In concept, they will issue up to \$20 billion semiannually, starting in February 2006. That is a very small amount of supply relative to the potential demand.

We see demand for Treasuries continuing at high levels, where central banks will continue to buy Treasuries on the front end of the curve but you could see, under this risk reduction scenario with no threat of accelerating inflation over a three- to five-year period, that there could be an imbalance of demand for the long end of the curve versus available supply.

As baby boomers move closer to old age they will look at their own needs to save given the lack of Social Security benefits. They may well be concerned about what their pension plan will look like when it comes time for them to retire. Individuals may follow the trend of risk reduction among pension funds and insurance companies, further increasing the appetite for longer maturity savings vehicles.

This leads us to a 3% to 4.5% forecast for a range of 10-year nominal Treasuries over our secular horizon. That is not a large range, meaning we expect a less volatile interest rate period over the secular horizon than we've seen in the past 25 years. Hence, this should be a good opportunity to sell volatility. Since we expect rates to trend down, in selling volatility, we would begin to favour selling puts versus selling calls. This is consistent with our desire to extend should there be a rate backup.

Initially, we expect the front end of the curve to benefit more than the long end as the rest of the world comes to grasp PIMCO's view that the Fed has less to tighten in this tightening cycle. But we would expect that our focus on the curve positioning will shift from a front-end focus to a back-end focus as we move through our secular horizon.

“As rates come down, we would expect to see U.S. rates fall faster than European rates...”

Q: How does the secular outlook affect PIMCO's strategy of favouring European bonds over U.S. bonds?

Powers: As rates come down, we would expect to see U.S. rates fall faster than European rates, so we have reduced our European bond concentration from its peak and we expect to continue to do that. The long end of Europe will benefit from risk reduction by European pension and insurance concerns. In addition, the configuration of short rates with the European Central Bank at 2% and the Fed at 3% and rising provides European bonds with the benefit of carry. Due to this carry advantage and the positive technical factors of European pension and insurance demand, we expect to continue to overweight European bonds versus U.S. bonds, although the overweight will be more modest than in the past.

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Q: Turning to specific sectors of the bond market, what is PIMCO’s secular view on corporate bonds?

Powers: It’s important to remember that this is going to be a tough global environment for corporations. The creative destruction that we’ve discussed in prior secular outlooks remains a concern in a world where global production is being repriced, led by the low cost producers out of Asia and, less so but also, some of the eastern European and Central European countries. Given this tough environment, we will want to remain in the top tiers of credit. Expect to see our credit posture remaining cautious but opportunistic through our secular horizon. We would expect over our secular horizon to be able to acquire increasing investment grade and high yield positions at somewhat cheaper levels.

Q: Would a Chinese currency revaluation have an effect on the corporate sector and would that affect PIMCO’s view on corporate bonds?

McCulley: On the Chinese revaluation issue, we think it will be a journey, not a big bang. There is a lot of push in the United States, led by Mr. Schumer in the Senate as well as Mr. Snow at Treasury, for China to move to a floating currency—effectively breaking up Bretton Woods II—as soon as possible. That’s not likely to happen; that’s political posturing.

We think that Washington understands that this is a marriage of convenience between the United States and China. As in all marriages, there has to be a little bit of give and take. The protectionist pressures in the United States are sufficiently high that the United States needs something from China right now. China wants to remain pegged to the dollar for all the good reasons that I articulated earlier that are in their own self interest, but we are likely to see some modest revaluation—and I stress modest—and probably a move to a currency basket, which would be a finetuning of the Bretton Woods II arrangement as opposed to an end to the Bretton Woods II arrangement.

In that context, I should note that during Bretton Woods I, between 1945 and 1971, there were periodic revaluations and devaluations but the system held, and that’s our base case scenario for China and the United States in this Bretton Woods II arrangement. The system holds but there will have to be some finetuning consistent with the bumps in the road that go along with any type of monetary union without political union.

“...the competitive pressures coming from Bretton Woods II are going to be an anchor on the corporate sector for a long period of time...”

From an investment perspective, a Chinese revaluation will tend to create more uncertainty in pure duration markets than it will in the corporate bond market itself, so I don’t think there are any draconian implications for the corporate bond market from the revaluation. That said, the competitive pressures coming from Bretton Woods II are going to be an anchor on the corporate sector for a long period of time because the monetary union between the United States and China effectively takes away pricing power from the corporate sector and pricing power covers up a lot of management sins, whereas when you don’t have pricing power then your mistakes get exposed. So I think the enduring impact on the corporate sector from the competition from China is hugely

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important and even with a currency revaluation that competition is not going to go away. We would focus on the implications for corporate profitability and the corporate sector of the global monetary arrangement more so than a flow of funds effect per se.

Q: How is the secular outlook affecting the firm’s view on mortgage-backed securities?

Powers: With a relatively benign 3% to 4.5% rate range, we would expect mortgages to be one of the better sectors. We would also note that due to this diversification of central banks around the world away from Treasuries and agencies into mortgages, that mortgages are poised to do very well over our secular horizon.

Q: Considering PIMCO’s view on the limited potential for further price appreciation in five-year TIPS, what is the firm’s view on the TIPS sector as a whole?

Powers: Considering the tremendous gains that we have reaped in TIPS over recent years, where they have dramatically outperformed nominal bonds, it would certainly be difficult to extrapolate that amount of outperformance into the future. Having said that, there is nothing that we see that would shift real rates much higher than current levels. Therefore, we would say that TIPS are an attractive hold.

Q: Aside from bonds, PIMCO has favoured commodities for some time based on expectations of higher inflation. How do the changes in PIMCO’s secular outlook for inflation affect the firm’s view on commodities?

Powers: Even in a 1% to 2% CPI world, commodities can continue to outperform. Our forecast is that a hard landing is not in China’s future. In this scenario, the emerging market countries should continue to benefit from exporting commodities. A slowing growth forecast for the U.S. and China eliminates the likelihood of the extreme \$100/barrel forecasts for oil prices but also maintains continuing demand for commodities. Commodities as an asset class are poised to do quite well.

McCulley: I would stress that this is a secular outlook as opposed to a cyclical outlook, because cyclically, commodities are related to the inventory cycle. But on a secular basis, commodities are all about where growth is coming from in the world. With this Bretton Woods II arrangement, the emerging markets—led by China—can actually have homegrown growth and are at the stage of development where their growth is quite commodities-intensive, kind of like the United States in the 1950s when everyone was moving into the suburbs and buying motor vehicles and building the interstate highways. So the nature of global growth has shifted towards more demand for commodities per unit of global GDP. That’s the underlying secular case for the allocation to commodities for a diversified investor. But there have to be cyclical warning signs there because commodities are inherently one of the more volatile cyclical asset classes.

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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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