

Cyclical Outlook

January 2010

Andrew Balls Discusses PIMCO's European Cyclical Outlook and Strategy



Andrew Balls

Mr. Balls is a managing director in the London office, a member of the Investment Committee and head of European portfolio management. (He leads PIMCO's European investment team, which is based in London and Munich, and manages European and global portfolios.) Mr. Balls was previously a global portfolio manager in Newport Beach and the firm's global strategist. He holds a bachelor's degree from Oxford and a master's degree from Harvard University. He was a lecturer in economics at Keble College, Oxford.

At the quarterly cyclical forum in December, PIMCO formulated its global economic outlook for 2010. In the interview below, Andrew Balls, managing director and head of European portfolio management, discusses the conclusions from the forum and their implications for portfolio strategy in the UK and Europe, including the importance of sovereign risk and country differentiation within the eurozone. He also explains the unique challenges of forecasting for the coming months given the dramatic long-term changes underway.

Q: One of the main conclusions from PIMCO's recent cyclical forum is that global economic recovery will be de-synchronised. What does that mean for the economies of the UK and Europe in 2010?

Balls: A global recovery is underway, but it is one that we expect to be differentiated across countries and across regions, in part reflecting the initial condition of countries as they entered the synchronised downturn of 2008–2009.

Overall at the global level, we see a bumpy and de-synchronised recovery, not a smooth and V-shaped return to old normal growth conditions. In particular, we expect considerably stronger growth in emerging market countries than in the eurozone, the UK and other Organisation for Economic Co-operation and Development (OECD) countries as a result of superior growth fundamentals in the emerging market world. For the eurozone and the UK, we are forecasting positive growth in 2010, but probably a little weaker than what will be seen in the US.

However, there is more uncertainty around the forecasts than usual, and it is even more difficult to identify the turning point in the economic cycle because larger, secular changes are also underway. Over the long term, we expect to see a major shift to lower growth in the developed economies, higher growth in the emerging economies and greater government intervention and regulation overall. PIMCO calls this new economic reality the New Normal.

Q: Do you expect the economic conditions and outlook for the UK to differ from those of the eurozone?

Balls: Compared with the core eurozone countries Germany and France, we see the UK as having a more difficult adjustment to make to the New Normal due to weaker initial conditions, greater ongoing need for deleveraging and, in the

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household sector, the need to rebuild savings, which are low compared with the savings rates you see in Germany or France.

However, the UK has benefited from more aggressive policy interventions and related to this, the depreciation of the British pound versus the euro and the dollar. We also consider the UK a more flexible economy than Germany or France. That is a benefit for the UK in terms of handling the big shocks we have seen hit these economies.

Taking all these factors into account, the growth forecast ranges are similar for the UK and the eurozone as a whole, and their outlooks are broadly similar, but the midpoint for the UK is a little bit higher than that for the eurozone.

Another important point is that while we see unexciting growth at the eurozone aggregate level, we expect to see considerable differentiation across member countries because of weaker initial conditions and greater deleveraging requirements in some countries.

Regional Cyclical Forecasts

Forecast	Real GDP		Inflation**	
	Current*	Q409 – Q410	Current*	Q409 – Q410
United States	-2.5%	1.5 – 2.5%	1.3%	0.0 – 1.0%
Europe	-4.1%	0.0 – 1.0%	-0.1%	0.0 – 1.0%
United Kingdom	-5.1%	0.5 – 1.5%	1.5%	1.5 – 2.5%
Japan	-1.4%	0.0 – 1.0%	-1.4%	-0.5 – -1.5%
China	8.9%	9.0 – 10.0%	-0.9%	3.0 – 4.0%
BRIM***	1.2%	5.0 – 6.0%	5.8%	4.0 – 5.0%

* For US, Gross Domestic Product (GDP) and inflation as of 30/09/09. For Europe and UK, GDP as of 30/09/09 and inflation as of 10/09. For China, GDP as of 30/09/09 and inflation as of 11/09. For Japan, GDP as of 30/09/09 and inflation as of 12/09. For BRIM, GDP is Q4/09 estimate and inflation is 12/09 estimate.

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

*** BRIM represents Brazil, Russia, India and Mexico.

Source: PIMCO

Q: Some of the peripheral eurozone states have seen their public deficits surge and their ratings downgraded. Could this possibly hurt the eurozone as a whole?

Balls: We have seen economic and fiscal stress in some of the smaller eurozone economies, notably Ireland and Greece. At the aggregate level, we think this will not be dominant for the eurozone's growth outlook. Some of the countries with the more difficult adjustments are rather small as an overall share of GDP. What happens in Germany, France, Spain and Italy is going to dominate to a large extent

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the aggregate picture. Together those four economies account for about 80% of the eurozone economy.

That said, individual countries will have difficult adjustments, and that is very important in terms of investment strategy – namely position in sovereign risk in European benchmark portfolios. We must invest based on clear analysis of the fundamentals, country by country, and ensure that we receive the appropriate compensation for taking individual country sovereign risk. Ultimately we see the eurozone as a very strong club, but macroeconomic performance and asset market returns are likely to be clearly differentiated. There have been various indications that cross-border support will be available in extremis, but the onus is clearly on individual member countries to take care of their own fiscal affairs. Adjustments are necessary due to either marked deterioration in fiscal deficits as a result of the crisis, or poor initial fiscal positions in terms of debt-to-GDP ratios, or in some cases both. This is a theme that we think will be very important for investors in 2010.

Q: Some of the largest eurozone countries applied less stimulus during the crisis than the UK and the US. Will these countries also face less of an economic challenge given that they will not feel the drag of stimulus removal in 2010?

Balls: For the most part we expect to see the big drag from fiscal stimulus removal coming further out in the forecast horizon – late 2010 into 2011 – rather than at the start of the year. The reason to be more cautious in terms of duration and interest rate risk in the UK or the US compared with the eurozone is the market uncertainty surrounding the end of the quantitative easing programmes in these countries.

The very clear example of these interventions is aggressive quantitative easing – the purchases of government bonds in the UK and the purchases of mortgages as well as government bonds in the US. In the eurozone, we have not seen this aggressive quantitative easing. We expect that ending these programmes in the UK and the US will pose a challenge. Meanwhile, we expect a more straightforward economic or market effect from the withdrawal of the special emergency measures taken in the eurozone.

However, this is not to say we expect an easy exit for the eurozone countries. Some member states have difficult fiscal adjustments to make. At the aggregate level, the prospect of the European Central Bank (ECB) scaling back its emergency liquidity provision measures has put pressure on some peripheral sovereign spreads.

There is also the question of how the ECB will exit its role of funding the banking sector by funding European asset-backed securities (ABS). When the private markets closed during the global financial crisis, banks relied on this funding from the ECB; returning this funding to the private market is not going to be an easy or quick adjustment. So there are certainly challenges at the eurozone level, but overall the removal of fiscal stimulus should be less difficult than in the UK or the US.

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Q: How will the removal of fiscal stimulus affect investment strategy?

Balls: The exit from policy measures is going to be an ongoing theme. We are cautious on duration in the UK and the US owing to the risks associated with the end of quantitative easing. This comes on top of the push and pull between a difficult cyclical and secular adjustment and increased government supply globally. In the UK there is also uncertainty over what the Bank of England (BoE) will choose to do with the stock of gilts it has bought during 2010. The BoE has bought gilts across the curve, whereas the Federal Reserve's quantitative easing purchases have largely been focused on mortgage-backed securities. So there is a bigger question mark over the exit strategy here for the BoE, whether it will continue to hold these bonds or whether it will at some point try to reduce those holdings.

Because the eurozone does not have large-scale quantitative easing programmes to unwind, we remain moderately bullish on eurozone duration. We also remain positive on covered bonds in the eurozone. The impact of ECB purchases of covered bonds is very minor compared with the quantitative easing programmes in the UK and the US, and we do not anticipate the winding down of that programme having a dominant influence on the market.

Q: What other factors is PIMCO watching that could influence portfolio strategy in 2010?

Balls: As mentioned, an important theme, related to fiscal stimulus, is the outlook for sovereign risk at a time when across the world we are seeing large increases in the issuance of government bonds. This is a crisis that started in the US housing sector and has spread to the consumer sector globally. The increase in government issuance as a result of large-scale government interventions reinforces the importance of sovereign risk and threats to the sovereign balance sheet in thinking about investment strategy.

On the eurozone side, there are going to be both risks and perhaps greater opportunities associated with differentiated performance across sovereign members of the eurozone club. On the UK side, in addition to the risk associated with the end of quantitative easing, there is also political uncertainty surrounding the elections, most likely happening in May, and the implications there for fiscal retrenchment and for fixed income markets. The chance of renewed pressure on the British pound remains a source of tail risk, a risk that poses a market crisis or systemic event that can severely hurt portfolio returns, in the UK.

Q: What does PIMCO expect for the euro and the British pound in 2010?

Balls: We maintain an overweight in high-quality emerging market currencies versus OECD currencies, in particular versus OECD countries that are not large commodity exporters. This means in euro-denominated portfolios we may want to be underweight the euro versus emerging market currencies; and in British pound-denominated portfolios we plan to be underweighted the British pound versus emerging market currencies. In accounts and in portfolios where we're limited to OECD currencies only, we may not take significant currency positions.

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Q: Interest rates are still at record low levels. What does PIMCO expect from the ECB and the BoE in 2010 – only words or also action?

Balls: Starting with the ECB, we expect a gradual withdrawal of the emergency liquidity provision but no dramatic moves. The ECB has made it fairly clear that while they want to withdraw emergency measures over time, and they do not want the market to extrapolate that this will be followed by any near-term increases in the policy rate. We see the ECB on hold through the first half of the year and do not expect any aggressive language from the ECB on that front. The banking sector's reliance on the ECB to fund asset-backed securities, which I mentioned earlier, remains an ongoing challenge.

In the UK, the BoE will most probably end its quantitative easing programme at the February meeting of the Monetary Policy Committee (MPC) but will likely avoid giving the impression that this is a precursor to imminent hikes in policy rates in the UK. We expect the BoE to be on hold through the first half of the year and quite likely for the balance of 2010; the MPC has made clear that it is focusing on the level of output rather than the growth rate per se in assessing the outlook for inflation and policy, and we anticipate a slow recovery in growth, meaning that spare capacity in the economy should keep a lid on core inflation pressures.

Q: Can you summarise how European investment strategy will reflect PIMCO's cyclical outlook?

Balls: We plan to maintain positive duration in our portfolios, but with a focus on the core eurozone countries rather than the UK or US. We look to focus more on high-quality spread opportunities rather than government duration in our portfolios. Also, we will likely be more neutral on curve compared with recent quarters. In European benchmark portfolios, we will continue to be close to neutral overall on peripheral risk, but we will look to benefit from good relative value opportunities between European sovereigns and also between European sovereigns and other sources of duration.

On corporate spreads, we remain roughly neutral overall and continue to overweight financials versus industrials as a core part of the strategy. We will likely continue to have an overweight in emerging market versus OECD currencies, and we will be looking for good opportunities in covered bonds, asset-backed securities, emerging markets and other sources of high-quality spread. We need to get the macro calls right, but we also plan to place significant emphasis on bottom-up trades and security selection.

Given the great uncertainty in the outlook and the significant rally in risk assets in 2009, we are starting the year more cautiously compared with six or 12 months ago. This is a difficult investment environment, and we anticipate a multi-year adjustment and not a quick return to business-as-normal. We will continue to look for good opportunities to take active risk as we navigate the cyclical outlook within the secular journey to the New Normal.

Thank you, Andrew.

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