



P I M C O

# Secular Outlook

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**PIMCO believes that secular economic, social and political trends exert the most powerful and sustained influences on bond markets. We define "secular" as the next three to five years. Our secular outlook guides the way we structure portfolios in terms of duration, yield curve positioning, sector exposure, credit quality and other risk measures. PIMCO develops its secular view at our annual Secular Forum, during which our investment professionals from around the world gather in Newport Beach for three days of discussion and debate about the global economy and financial markets. We invite outside speakers – experts in economics, finance, history and politics – to supplement our internal analysis. The following is a summary of our 2005 Secular Outlook:**

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## **DISINFLATION WINS THE TUG OF WAR**

Over the past few years PIMCO's Secular Forums have described the tension between disinflation and reflation. We now proclaim the winner to be disinflation, which will foster an environment of low and even declining global interest rates. A global free trade-based economy with a surfeit of cheap Asian labor, along with the limited inflationary response from fiscal and monetary stimulus will contain inflation. It will be difficult for the U.S. to generate inflation greater than 3 percent even if already low interest rates fall further. The same goes for Euroland and Japan, with potential for 1-2 percent CPI throughout much of the global economy over the next five years. The following are key elements of our economic outlook:

■ **Bretton Woods II Has Life** – The so-called Bretton Woods II arrangement, whereby Asian central banks invest their savings in Treasuries to finance the U.S. current account deficit, will continue. While a substantial Chinese currency revaluation or an erosion of U.S. consumer confidence could eventually undermine BW II, mutual self-interest should sustain this de facto monetary union for the time being. It provides Asian producers with relatively cheap, export-stimulating currencies. U.S. consumers, meanwhile, obtain low cost imports and can borrow at interest rates as much as 100 basis points lower than they otherwise would be.

■ **The "Pump" Is Near Its Limit** – Inflation remains relatively benign everywhere in the global economy, except in asset prices – our homes, stocks, corporate bonds, etc. In contrast to periods when wealth gains arose from surging productivity or advances in technology, over the last five years valuations of risky assets have been pumped up artificially by Federal Reserve Chairman Alan Greenspan's low interest rate policy. The goal has been to create wealth that will sustain U.S. consumption and keep the global economy going. The Pump is best exemplified by five-year TIPS (Treasury Inflation Protected Securities) yields, which have plunged from 4 percent five years ago to only 1 percent today. If 3 percent inflation is all the U.S. economy has gotten from the Pump to date, it is hard to see how we will get more inflation even if real yields decline from current low levels.

■ **Leveraged Investors Pose Systemic Risk** – Abundant liquidity in financial markets associated with the Pump has allowed for increased leverage and also quicker exits from investment strategies. Leverage throughout the global financial system will

pose a danger to risk-oriented markets such as stocks, high yield bonds, complex debt structures such as collateralized debt obligations (CDOs) and real estate as owners realize that their returns can no longer be pumped up anywhere near double-digit expectations. An unwinding of levered structures, which could occur even amid economic growth, would roil financial markets and shake confidence.

■ **Geopolitical Risks** – Flash points around the world include North Korea, Taiwan and Iran. An eruption of any of these areas, while impossible to forecast, could undermine the economic stability provided by BW II.

## **INVESTMENT IMPLICATIONS**

■ **Bullish for High Quality Bonds** – Strong demand for Treasuries should continue from Asian central banks, as well as private global bond investors who will sense no threat from accelerating inflation. Moreover, private and public sector pension fund changes are under way that will likely mandate increased allocations to long term bonds to accommodate ageing populations in many developed economies. These changes are for the moment further advanced in Euroland than in America.

■ **Low Global Interest Rates** – A range of 3-4½ percent for the yield on 10-year nominal Treasuries should prevail over the next several years. Yields on Euroland bonds will be slightly lower due to their structural economic problems, disinflationary incorporation of new Central and Eastern European entrants and growth-inhibiting demographics.

■ **Low Returns for Riskier Assets** – Price appreciation in real estate, stocks and corporate bonds can be pumped only a little further by monetary policy given already low yield levels. Assuming a starting point of 4 percent on five-year real yields, the Pump is ¾ of the way complete at today's 1 percent real yield, since zero is the practical limit. PIMCO is not forecasting a collapse in home values or other risky assets, but we believe we are surely heading down the home stretch of the U.S. race to prosperity based on asset price appreciation.

■ **Commodities Could See Gains** – Commodity price gains are less dependent on lower and lower financing rates than appreciation in other assets. Supply constraints coupled with continued strength in worldwide demand should benefit commodities over the next several years.

## WHAT THE EXPERTS SAY

**PIMCO taps the best minds in economics, finance, politics and history to help formulate our Secular Outlook. At this year's Secular Forum we invited several outside speakers to supplement our internal analysis, discussion and debate. Here is a summary of what they had to say.**

### MICHAEL DOOLEY

*Professor of Economics at the University of Santa Cruz*

Professor Dooley's central thesis was that the revived Bretton Woods system (i.e. Bretton Woods II) can continue over a secular time frame. The U.S. current account deficit is an integral and sustainable feature of this successful international monetary system. BW II works because China is fully committed to employing its vast supply of underemployed workers and has no incentive to stray from this goal. The U.S. is willing and able to continue supporting this relationship because it benefits from cheap imported goods and low real interest rates. Professor Dooley sees no reason why BW II cannot continue for another 10 years because of the parties' mutual self-interest. Adjustments in the near term could include a small revaluation of the Chinese currency and introduction of minor protectionist measures in the U.S. and Europe. Eventually BW II will evolve as the excess labor pool in developing economies is exhausted and their real wage rates rise.

### JONATHAN WILMOT

*Managing Director and Global Strategist,  
Credit Suisse First Boston*

Mr. Wilmot argued that asset market bubbles are endemic to the Bretton Woods II system. The system provides abundant liquidity and a low cost of capital that leads to short-run overinvestment, asset price overshooting and the potential for investor disappointment. Today the global economy is in a period of excess supply brought about by globalization, deregulation and secular gains in productivity. Housing bubbles in the U.S. and U.K. coupled with an investment bubble in China could be signaling an economic slowdown. Even so, Mr. Wilmot agreed with Professor Dooley that it is not in the interest of either the U.S. or China to break out of the BW II system, which could remain in place for a long time. Global long term interest rates will be lower going forward, potentially amplifying the effects of market bubbles.

### OLIVIA MITCHELL

*Professor of Insurance and Risk Management and Business and Public Policy at the Wharton School of the University of Pennsylvania*

Professor Mitchell argued that global ageing raises new risks for retirement systems and will lead to substantial changes in private and public pensions. As higher burdens are placed on public government-run old age support, the public will rely less on it. Corporate and private savings accounts will become more prominent. Increased reliance on private accounts will, however, present serious concerns in all phases of the retirement process. One issue is that accumulation of retirement savings is not now compulsory. Another problem is that the average worker lacks investment sophistication. With regard to the U.S. Social Security system, the solution proposed by the President's Commission to Strengthen Social Security, on which Professor Mitchell served, is putting Social Security on a self-financing basis. This would include indexing benefits to prices instead of wages, creating voluntary personal retirement accounts and enhancing the "safety net" by boosting lowest earner benefits to 120 percent of the poverty line.

### MICHAEL KLARE

*Professor of Peace and World Security Studies at Amherst, Mount Holyoke and Smith Colleges and the University of Massachusetts at Amherst*

Professor Klare maintained that the diminishing supply of oil, water, minerals, timber and other resources will lead to increased competition among nations that could turn into armed conflict. In the U.S., oil has been seen as a matter of national security ever since President Roosevelt arranged for American protection of the Saudi monarchy in return for privileged access to Saudi oil. Increasingly, China and Russia are viewing oil through the same lens. While markets and prices have a role to play in the allocation of natural resources, markets alone cannot resolve the looming conflicts.

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