

## Spotlight

October 2006

### William C. Powers Discusses PIMCO's Cyclical Outlook and Global Strategy



#### William C. Powers

Managing Director and Senior Member of PIMCO's Portfolio Management and Investment Strategy Groups

Mr. Powers 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.

*Bill Powers is a senior member of PIMCO's Portfolio Management and Investment Strategy groups, and plays a key role in formulating the firm-wide viewpoints that shape every PIMCO portfolio. These views are guided by PIMCO's cyclical Economic Forums, which examine the outlook for the next six to 12 months, and the annual Secular Forum, which focuses on the three-to-five year outlook. Paul McCulley recently discussed the major conclusions from PIMCO's September Cyclical Forum, and in the interview below, Mr. Powers discusses the details of the firm's global outlook and investment strategy following the September Forum.*

#### **Q: Before we discuss PIMCO's investment strategy following the September Cyclical Forum, could you summarize the firm's cyclical macroeconomic views for those who may have missed Paul McCulley's recent summary?**

**Powers:** PIMCO voted for a slight stagflationary outcome in the U.S. at our latest Cyclical Forum. The question debated by our global investment professionals was the extent of the current economic slowdown, not whether there would be a slowdown. While our most likely scenario is a soft landing of 2%-2.5% GDP in the U.S., we recognize the possibility that a hard landing in the housing market can trigger a sharp slowdown in consumption and risk aversion in corporate investment and hiring.

In studying the dynamics and externalities of a housing slowdown, we appreciate that housing slowdowns occur over time rather than immediately. We note home price increases have moved from double-digit levels over the past few years to only slight increases recently. Some of the hotter housing markets have seen declining prices year-over-year. As homeowners recognize a peak in prices, the supply of homes coming onto the market has increased dramatically. Buyers have finally developed caution after years of speculative zeal. This newfound caution among buyers will cause transaction volumes to decline significantly. This reduction in transaction volumes has a direct effect on employment in the vast housing related industries, including, as Scott Simon, PIMCO's MBS expert, has pointed out, lower demand for the stuff new homebuyers buy when they purchase a home. Low home price appreciation also can have negative consequences for consumption due to lower and declining mortgage equity withdrawals.

We are aware of the other risk to our central forecast—the risk that the economy is resilient and rebounds from the current slower growth trend. The risk of this scenario is that the Fed remains biased toward tightening. We believe this scenario has a very low

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likelihood. Hence, when we weigh the risks to our central soft landing scenario, we believe, among the less likely scenarios, that the hard landing scenario has a higher probability than a rebound scenario. The reasons for our confidence in a slowdown scenario are many, but the most important is the weight of a housing slowdown within GDP calculus and the dynamics and externalities of a slowdown from current extended levels.

We recognize that corporate profits remain elevated and corporations are flush with cash, but this money is unlikely to provide a lift for the economy unless it is used for hiring and investment instead of stock buybacks and mergers and acquisitions.

Among the triggers which will determine whether the outcome is a soft or a harder landing scenario are 1) whether national home prices on a year-over-year basis become negative, 2) lower employment amplifying the housing slowdown, 3) energy costs remaining at high levels, crowding out other consumption, and 4) the restrictive influence of rates across the curve at current levels, including the restrictive effect of resets of existing adjustable rate mortgages.

### **Q: How is PIMCO's forecast of a soft landing in the U.S. influencing the firm's view of central bank policy around the world?**

**Powers:** Our cyclical forecast of a soft landing in the U.S. raises the possibility that the Fed will leave rates elevated for a longer period of time. The market is discounting a modest ease by the Fed after its typical post-tightening pause of six months. If economic data is merely mixed over the next few quarters with GDP growth and inflation data remaining at current levels, then the market risks selling off. We believe the stable-to-higher growth scenario is unlikely. The market's expectations that only modest rate cuts can stabilize growth underestimate the job ahead for the Fed and overestimate the future path of U.S. GDP. In fact, an ease in the first half of 2007 with multiple additional eases of as much as 100-150 basis points will be important to achieving the soft landing scenario. Hence, the primary scenario at this point is that rates decline further and that the Fed will have to ease more than what is currently priced into the market.

While the Fed is currently restrictive, other central banks like the Bank of Japan, the Bank of England's Monetary Policy Committee and the European Central Bank are still moving in the tightening direction. Like the Fed, these central banks are concerned about the risks of inflation, inflated asset prices, and normalizing risk premiums. They are using the interim between the Fed's last tightening in August and the Fed's first ease as a window of opportunity to normalize their own rate structure and other risk premiums, as well as to contain the effect of prior accommodative monetary policy on asset prices.

### **Q: How is PIMCO applying these views on central bank policy to determine the relative value of different bond markets around the world?**

**Powers:** As we have discussed before, we see a totem pole of relative value and risk/reward in global sovereign debt. In this construct, fixed income markets are ranked from top to bottom depending on where each central bank is along the path to removing accommodation and normalizing policy. Thus, we see the most value in the

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U.S. because in our mind the likelihood that the Fed funds rate will remain above the market's expectation for a 4.5%-4.75% Fed funds rate in 12-24 months is much lower than the likelihood that the Fed will have to cut rates to well below 4.5%. If we are wrong, we don't believe we will be wrong by very much or for very long. Experience has shown that finance-dependent economies cannot endure high and flat rate configurations for very long. Given the lagged effect of monetary policy tightening on the economy, as the tightenings of the last 12 months have had their inevitable effect, the slowdown and risks of tipping will get the attention of the Fed. Hence, we have moved our duration target for the U.S. to five-eighths of a year over the benchmark.

After the U.S. market, we see value in the front end of the U.K. curve. While the U.K. does not suffer from housing supply excesses and current account imbalances, the market is discounting an unsustainably high policy rate in 12-24 months of close to 5.25%. Since U.K. homeowners finance their mortgages with floating rate debt, the recent back up in rates in the front of the U.K. yield curve will likely moderate its housing markets, and with it consumption, sooner rather than later.

Next down the totem pole is Europe, which has become more attractive since our last discussion in March as a result of the ECB's progress in tightening rates toward their end point, now thought by the markets to be a relatively restrictive 3.75% by December 2007. The worried vigilance articulated by the ECB regarding inflation appears to be in contrast to the change in the economic data and surveys (IFO and ZEW) in Europe that indicate a slowdown in Europe's future as well. Although we expect Europe's economy to hold up better than the U.S. economy, we see more value in Europe now than six months ago.

Japan is at the bottom of our relative-value totem pole. Japan surprised us over the last six months as growth and revised inflation data forced a moderation of the Bank of Japan's path toward rate normalization. Due to policy mistakes of the past that have been blamed for prolonging and derailing Japan's path out of economic malaise, the Bank of Japan now appears extremely cautious in its implementation of policy normalization. With rates at current levels and only modest expectations for tightening ahead, and the door closing to further tightenings once the Fed eases next year, the Bank of Japan should exit this tightening cycle in a more accommodative posture than we thought six months ago. While this makes us cautious on Japanese rates at current levels, it also leads us to believe that the global risk premium normalization from tightening in Japan is less worrisome to carry trades and spread markets. Accordingly the indigestion in risk markets in May and June proved only temporary, but we believe longer-term these carry and spread markets remain vulnerable to an increasingly tight global monetary policy configuration.

### **Q: Where does PIMCO see value in terms of the yield curve?**

**Powers:** We have a preference for the short end of the yield curve, particularly in the U.S. and U.K. markets. Rates in the U.S. 10-year note and further out the curve have less to gain from a return to a normal, positively sloped yield curve than do rates in the short end. We view intermediate and longer rates in the U.S. as fairly priced under our ranges of possible future economic scenarios. We see the sweet spot of U.S. duration

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in the second year of the eurodollar futures complex, which we expect to benefit the most in a scenario where the Fed eases for the first time six to nine months from now.

In the U.K., the long end of the curve looks expensive due to regulatory-induced demand by U.K. pensions, which leaves the long end of the U.K. vulnerable to several possibilities: regulatory relief, recognition by U.K. pensions and their consultants that the long end offers little relative value, and opportunistic supply by the U.K. Debt Management Office. In contrast, the long end of the European curve still appears to offer more value relative to the front end, but PIMCO agrees with the estimates for a 3.75% end point in December 2007 for the ECB policy rate: 3.75% certainly appears to be a fair end point and perhaps offers some value as well.

In Japan, as the least favourable of the major sovereign fixed income markets, we prefer short positions rather than long positions. If we had to favour one end of the yield curve in Japan versus the other, we would still prefer the longer end of the curve versus the shorter end. Hence, curve-flattening strategies in Japan are a possibility for us.

**Q: What does PIMCO expect in terms of market volatility and how does that influence the firm's long-running strategy of selling volatility via options strategies and through holding mortgage-backed securities?**

**Powers:** We expect low risk premiums to normalize. Among these low risk premiums is volatility. Risk premiums are in the process of being normalized by central banks, which are either already in a tight configuration like the U.S. or moving to a tighter configuration, as in the U.K., Europe, and Japan, among other global central banks. In this process, as we see risk premiums normalize, we expect that the current very low level of volatility will be among the risk premiums that are normalized. The market has enjoyed the benefit of transparent and stimulative global monetary policy, as well as a global savings glut, primarily domiciled in Asia, Russia and the Middle East. The transparency offered by central banks and the enormous pools of liquidity moving into sectors of the market offering higher income have simply taken a lot of the risk premiums out of the market, including volatility premiums.

As these central banks complete their tightening process and as the U.S. economy endures the Fed's current restrictive posture, we expect volatility to increase as it typically does around an economic turning point. Therefore, we have become cautious on our traditional volatility sales. Among these are selling straddles on Treasury futures, and running large concentrations of mortgage-backed securities, which is a volatility sale.

We therefore have reduced our core mortgage holdings with the anticipation of being able to put them back on at cheaper levels. We do note that given the low compensation for risk offered in spread markets, including investment-grade and high-yield corporate bonds as well as emerging market bonds, the current income offered by mortgages is actually relatively attractive, which has moderated the extent of our reduction in mortgage concentrations.

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**Q: How does PIMCO's outlook affect the firm's view of Treasury Inflation Protected Securities (TIPS)?**

**Powers:** Our forecast rests in part on the fulfillment of Fed Chairman Ben Bernanke's expectation that core inflation will be moderating in the next six to 18 months. TIPS have underperformed nominal Treasury issues after break-even inflation levels peaked in the May-June period—when the market expected that inflation risks in the short term could be increasing. We have moved past that peak with commodities now discounting the global slowdown and removing some of the fear premium from commodities prices. With inflation risks moderating, including risks from employment, which we also expect to see decline ahead, TIPS could underperform further in the short run. We note, however, that value is returning to the TIPS market for long-term holders now that break-even inflation rates priced into TIPS are approaching the 2.25% level on headline inflation, which we believe is a long-term support level.

**Q: PIMCO has long favoured municipal bonds as a defensive strategy against rising rates in the U.S. Has that view changed with the firm's latest cyclical outlook?**

**Powers:** We have considered municipal bonds a very attractive defensive strategy for two reasons. One is that municipal yields in the long end were at very attractive historical ratios to Treasuries. The second reason is that in an environment where we perceived a risk that rates could back up toward the high end of our 4%-5.5% secular range expected for the 10-year U.S. Treasury note, municipal bond yields of close to 5% were very attractive to retail investors. This was especially so, given risks that tax policy could become more restrictive in the event that the Republicans were unable to make tax cuts permanent.

It now appears that the allure of municipals as a defensive strategy is not as high as we perceived six months ago. Rates appear to have peaked, and with indications now that the Republicans can hold a majority in the House of Representatives, the prospect of a change in tax policy is less likely to benefit munis as well. Accordingly, we plan to look selectively for opportunities to sell munis going forward.

**Q: Following PIMCO's Secular Forum in May, you noted that the firm has increased its tolerance for currency exposure in anticipation of a downturn in the U.S. dollar. What is PIMCO's view on the currency markets following the September Cyclical Forum?**

**Powers:** We have increased our foreign currency concentrations, reflecting what we believe is a 6-12 month convergence of global short-term rates. We note, with some frustration, the current large gap between policy rates in the U.S. and Japan. This gap represents the negative carry of a position that is long yen and short dollars. We expect that this large gap will decrease by more than the market discounts. This view is primarily based on our expectation for a much lower Fed funds rate than the market is currently discounting, rather than an expectation of a much faster tightening pace by the Bank of Japan. That will lead, in our opinion, to a large, but perhaps long-term, appreciation of the yen versus the dollar.

We will admit that this negative carry trade makes the cost of remaining in this concentration very expensive while the yen-dollar relationship remains stable. But we

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take seriously the discussions of the G-10 finance ministers and the IMF regarding the need for currency flexibility, including the likelihood that the Chinese RMB will continue to revalue. Treasury Secretary Hank Paulson's contributions to the U.S.-China dialogue we believe will be constructive. The RMB has revalued by about 5% in the last 12 months and we would expect similar appreciation over the next 12 months. As the RMB appreciates, we would expect the yen to follow, as it is certainly more palatable to the Japanese to see their currency strengthen in an environment where the RMB is being re-priced as well. The support Japan's economy receives from exports to China further supports the case for yen appreciation vis-à-vis the dollar. The expectation for continued growth in China limits the extent of any prospective slowdown in Japan.

We also expect the euro to appreciate versus the dollar given the U.S. current account imbalances, the expected convergence between U.S. and European policy rates and the likelihood that the U.S. economy will slow more than the European economy. We see relatively greater opportunity for the yen to appreciate, and expect to maintain greater concentrations in yen, but we like both the yen and the euro better than the dollar going forward.

Additionally, our emerging market team has highlighted the benefits of a growing current account surplus in Russia and the positive carry associated with holding the ruble versus the dollar. Hence, we have added a concentration in the ruble of about 1% to our core emerging market currency basket.

### **Q: What is PIMCO's view of the emerging markets more broadly?**

**Powers:** Value in the emerging markets has moderated as spread levels have narrowed. When comparing spread levels in the potentially more volatile emerging markets to other sectors like mortgages, we now see less compelling relative value than we've seen in prior years. We still note that the higher-quality emerging markets, which we identify as Mexico, Russia, and Brazil, have solid and improving fundamentals.

We would also anticipate that with very little slowdown anticipated from China the demand for commodities that has allowed these developing regions to enjoy current account surpluses will moderate only slightly, leaving strong economic fundamentals in these countries going forward. It is really the low spreads offered in these markets that make them relatively less attractive, rather than a fear that a slowdown in the U.S. would trigger contagion in these markets. Our forecast in the U.S. is for a soft landing, which is a scenario that doesn't create a contagion risk in the emerging markets. It is simply an issue of compensation for risk with spreads at current narrow levels. We are certainly aware that emerging markets typically do not perform well when the U.S. has a hard landing, which is the primary risk to our base case, soft landing scenario. Today's emerging market menu has far healthier choices versus that of 10-25 years ago.

I would also add that we believe local emerging market debt, denominated in local currencies, currently offers attractive relative value opportunities. Restrictive short-term rates and very high real rates in these markets make them attractive not only from a carry standpoint but also from a fundamental value standpoint. These markets are now

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far more liquid as the developing countries have depended on, and are committed to, these markets as their preferred source of funding.

**Q: Finally, it seems that PIMCO's overall strategy of favouring the short-end of the yield curve while limiting exposure to strategies and sectors of the market that tend to provide income, results in a portfolio with low or perhaps negative carry. How long is this unusual portfolio structure likely to continue?**

**Powers:** The current "V"-shaped Treasury yield curve is one that occurs very infrequently, typically as a symptom of an economy in transition, and is not a curve shape that we would expect to continue far out into the future. We also recognize, with risk premiums still very low and in our view likely to increase in the future, that it makes sense for PIMCO to keep its powder dry at the temporary expense of managing portfolios with negative carry. Our goal is for our portfolios to be characterized by positive carry within six to nine months as risk premiums normalize and opportunities to put carry back into the portfolio at attractive levels present themselves.

**Q: Thank you, Bill. We look forward to speaking with you again after PIMCO's next Cyclical Forum, in December.**

### Singapore

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The ZEW index is based on a monthly survey of about 350 institutional investors about their expectations for the economy over the coming six months. The German IFO index tracks business sentiment about current and future business conditions.

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Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

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