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

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Mr. Powers joined the firm 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 22 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 December Cyclical Forum, and in the interview below, Mr. Powers discusses the details of the firm's global outlook and investment strategy following the December Forum.

Q: What were PIMCO's overall conclusions from the December Forum?
Powers: The December Forum ratified our expectations for a soft landing in the U.S. with growth around 2% and with inflation, as measured by the core PCE,[1] expected to be at the top end of the Fed's comfort zone, which is 2%. Hence, we affirm that the slowdown in the U.S., which began in housing, continued into the auto-manufacturing sector, and is forecast to spread to other sectors, including the manufacturing sector with the Institute of Supply Management (ISM) Purchasing Managers Index now below 50, continues. Based on that forecast, we would expect to see inflation move down into the Fed's comfort zone within their forecast period.

Our forecast for Europe is very similar to that of the U.S., although we note that European growth is increasing relative to the U.S. Over last few years, we would have predicted that U.S. growth would have been higher than Europe's. Now, we expect European GDP growth to be 2% and headline consumer price inflation of 2% over the next 12 months, very similar to our U.S. forecast. As with Europe, Japan's relative contributions to global growth have increased. Our forecast is for 2% GDP growth in Japan, but with far lower inflation prospects. We expect core inflation of 0.2% for Japan over next 12 months.

Q: The European Central Bank (ECB) and Bank of Japan (BoJ) have raised interest rates in an effort to normalize monetary policy after a long period of accommodation. How would a slowdown in the U.S. influence the path of policy normalization in Europe and Japan?
Powers: The European Central Bank and Bank of Japan have a window of opportunity to continue to normalize policy while the Fed currently remains on hold at a restrictive 5.25%. However, we think the path of policy normalization at the BoJ and ECB may be

[1] Core PCE is the personal consumption expenditures index, excluding food and energy

threatened if growth in the U.S. slows more than expected, perhaps due to a harder recession in housing and a more pronounced effect on the U.S. consumer. We think it would be very difficult for other central banks to continue to tighten once the U.S. economy has met the burden of proof that would lead the Fed to ease.

Q: At what point would the Fed consider easing? How high is the burden of proof regarding the slowdown in the economy?

Powers: We would be surprised to see the Fed easing any time earlier than the March meeting, but it would make perfect sense to us to see the Fed beginning to ease at either the March meeting or at the May or June meetings. While the economy is showing signs of slowing, inflation remains above the top end of the Fed's comfort zone, employment growth has been surprisingly sturdy, and recent data on retail sales indicate a strong holiday shopping season, perhaps aided by the decline in interest rates from their peak and also by the drop in energy prices.

However, we still believe that most of the employment effects of a slower housing market are still to come. Considering all the purchases people make when they move into a new home—furniture, fixtures, appliances and even other durables including cars—it makes sense that the housing boom was responsible for about half of the employment growth in this latest cycle, which has produced close to six million new jobs. Now, with home price appreciation going from double-digit growth to flat and perhaps declining in 2007 on a year-over-year basis, we will likely begin to see layoffs in the various housing-related industries. As a result, we would expect to see non-farm payroll growth begin to decline from current levels of almost 150,000 monthly levels to below 100,000, and perhaps below 50,000.

In such a slowdown, and in light of the ISM index below 50, the Fed would ease the restrictive posture, moving the Fed funds rate to a neutral rate, which we would describe as something closer to 4% to 4.25%. Housing momentum has shifted with risk aversion moving into the housing market. To arrest the falling housing market, it is very likely the Fed will need to move into stimulative mode. That could well take Fed funds below 4%.

Q: Where does PIMCO expect the European Central Bank to end its tightening campaign?

Powers: The ECB is lagging behind the Fed in its path toward normalization. The Fed tightened at a measured pace of 25 basis points in 17 consecutive moves, taking the Fed funds rate from 1% in 2004, which was a very accommodative level, to a very restrictive level of 5.25% when they tightened for last time, in June 2006. The ECB began tightening after the Fed and has had a less defined tightening path. As a result, the ECB has tightened only 150 basis points, from 2% to 3.5%, whereas the Fed has tightened 425 basis points.

The market realizes that the ECB is now data dependent. In the past, the ECB has been transparent with respect to its policy orientation. Hence, the market has discounted with accuracy what the ECB would do at each one of its decision points. Now that the ECB has reached 3.5%, the question is whether the ECB has more to do. They could very well move to 3.75% or 4%, but it is also possible they will pause at 3.5%.

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Q: What is PIMCO's outlook for U.K. monetary policy? Is the Bank of England also likely to pause?
Powers: We see a two-track economy in the U.K. The now very small manufacturing sector has weakened and wage growth outside of the financial sector is quite modest, but, on the other hand, housing prices are rising and unemployment is relatively low, which makes the Bank of England's Monetary Policy Committee (MPC) wary.

Another rate hike is possible in the U.K. but we think the MPC is very close to being done. The "have-nots" in the U.K. economy are straining right now. Any further tightening would put a further restrictive effect on the U.K. economy, given that the U.K. mortgage market is one in which policy rates feed directly into the cost of financing mortgages. Hence, the MPC will be very cautious in evaluating whether to tighten again.

Given the imminent signs of further slowdown in the U.S and the possibility that slower U.S. growth will create slowdowns elsewhere in the global economy, including the U.K., we think the MPC will soon pause. Perhaps their next move will be a rate cut.

Q: Moving to Japan, does PIMCO agree with the market's expectations for future rate hikes by the Bank of Japan?
Powers: We have seen signs of slowing growth in Japan. We see little money supply growth and inflation has been restated to just modestly positive, with the distinct possibility of negative inflation prints in 2007. The Bank of Japan has no reason to tighten policy other than to normalize policy at positive levels of real interest rates. Hence, an expectation of higher inflation is required to warrant the BoJ moving aggressively. We expect the BoJ to tighten by 25 basis points in February, bringing their policy rate to 50 basis points, but future tightening sometime in the second half of 2007 is unlikely if the Fed already has begun its easing cycle.

If the soft-landing scenario does not play out in the U.S. and if the U.S. tips toward slower growth, then the market's expectation of further tightening by the BoJ beyond a policy rate of 50 basis points may not come to fruition. We believe the market is perhaps overestimating the likelihood of policy moves for Japan.

Q: When we spoke following the September Forum, PIMCO expected the short end of the U.S. yield curve to outperform other global rates as the market began to price in Fed easing. Has that expectation proved correct?
Powers: When we spoke three months ago, December 2007 eurodollar levels were just under 5%, at 4.97%. Today, they are 4.80%. Hence, our outlook for a repricing of the eurodollar curve has been on target. The front end of the U.S curve moved far more, and in a different direction, than the front end of the European curve, the U.K. curve and the Japanese curve. In Europe, the December 2007 euribor rate has moved from 3.85% in September to 3.94% in December, up 9 basis points. Eurosterling has moved from 5.24% in the middle of September to 5.44% in December, up 20 basis points, and in Japan, the euroyen has moved only slightly, from 95 basis points to 97.5 basis points, a slight rise of only 2.5 basis points.

In last three months, our forecast for slowing in the U.S. and an increased share of global GDP for Europe, the U.K. and Japan has been confirmed by the reconfiguration

of rates in the front end of global yield curves with Europe, the U.K. and Japan underperforming the U.S.

Q: Does PIMCO still believe the short end of the U.S. yield curve offers the best relative value globally?

Powers: Absolutely. In a finance-based economy, the Fed will have to move from a restrictive policy to a neutral policy to rekindle economic growth after slowing the economy to move inflation back into its comfort zone. Given the lagged effect of leaving rates in either an accommodative or a restrictive level for a long period of time, typically the Fed makes the mistake of overshooting. Thus, we anticipate that the Fed will have to move rates back into at least a slightly stimulative posture to normalize housing-related activity and other economic activity.

While we expect the front end will outperform the intermediate part of the U.S. yield curve given our expectations for a change in Fed policy, we also note that 10-year rates have increased from 3.75% to a peak of 5.25%. Before this cycle is over, it makes sense to us that 10-year rates will likely return to 3.75%. With 10-year rates currently around 4.60%, we would argue that this correction is only half completed. Hence, we would anticipate maintaining a duration overweight of about a half-year relative to our benchmarks, as well as a concentration on the front end of the U.S. curve.

Q: Aside from the front end of the U.S. yield curve, does PIMCO see value in other yield curves around the world?

Powers: In addition to the front end of the U.S. yield curve, we also affirmed positions on the front end of the curve in the U.K. and Australia. As I mentioned earlier, it is also possible that policy in Japan is less than that discounted into the market and that the ECB could pause at 3.5%. While we would argue that the front end of the U.S., U.K. and Australia curves offer better risk/return prospects, we would also argue that Japan and Europe, if they are not now, will soon be opportunities to diversify our front-end exposure across global curves as well.

We note also that other parts of global yield curves offer value. We spent a great deal of time at the December Forum analyzing global asset-liability management initiatives among pension and insurance companies that are seeking to reduce risk versus their very long duration benchmarks. This asset-liability management cycle is largely complete in the U.K., making the long end of the U.K. extremely expensive relative to the front end of the U.K. curve. However, because of different time periods for the implementation of these asset-liability initiatives, we see the potential for continued flattening in 10-year notes versus 30-year bonds in the long end of Europe, the U.S., and Canada. In Japan, insurance company initiatives could also prompt the very steep part of the Japanese curve, from 10-year notes to 30-year bonds, to flatten as well.

Hence, in addition to exposure on the front-end of the curves I mentioned, we would expect to underweight the long end of the U.K., as that cycle is all but complete, while looking for opportunities in 30-year bonds versus 10-year notes in the U.S., Japan, Canada and Europe. Currently, the 10-year maturities of those curves look more fully priced to us than the long maturities.

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Q: Turning to other sectors of the bond market, does PIMCO continue to underweight corporate bonds?

Powers: We continue to maintain a one-year underweight in investment-grade corporate bonds. Investment-grade corporate spreads have tightened significantly for a number of good reasons: de-levering by corporations, high levels of corporate profits, policy pools of money seeking diversification into income sectors, hedge funds and others looking to this sector for carry, structured products looking to this sector as a diversified source of income, and also levering of this sector in absolute return products.

However, spreads have tightened to levels that we think limit the likelihood of further tightening. In fact, given the macroeconomic risks we've discussed, including the possibility of a harder landing in the U.S. and its effects on the consumer and possibly our trading partners, there is the possibility of pronounced spread widening.

Hence, we see asymmetric risk in corporate bonds. The cost of underweighting investment grade corporates is minimal given today's tight spreads, the likelihood of additional tightening is only modest, and the chances that spreads could widen is actually quite good, or at least a lot more likely than spreads remaining here or tightening further.

Q: What is PIMCO's view on mortgage-backed securities (MBS), both in terms of value and as an opportunity to sell volatility?

Powers: We expect to maintain an overweight in mortgage-backed securities of about three-quarters of a year of duration. As interest rates have come down, higher coupon MBS—the 6% and 6.5% pass-through coupons—have become marginally cheap relative to swaps. We would expect further tightening, not only due to reduced supply of mortgages but also from diversification bids in this sector from some of the large policy pools of money looking to add income and diversify out of Treasuries and agency debentures.

We also note that in a market where volatility levels have come down quite a bit, mortgages should offer a marginally better opportunity to sell volatility than selling options. We acknowledge that selling volatility via MBS is somewhat risky given the low level of volatility assumed in the market. We expect MBS positions to outperform swaps.

Q: How is PIMCO's global outlook influencing the firm's strategy in emerging markets?

Powers: Based on our forecast for a soft landing in the U.S., trend growth in Europe and Japan, and continued growth in China, the emerging market economies are likely to continue their journey towards reflecting not only investment-grade characteristics but the characteristics of developed country fixed income markets. Thus, we see opportunities in local-currency bonds, both in Brazil and Mexico. We also see value in some emerging market currencies, including Mexico, Brazil, China, Russia and South Korea, just to name a few. Hence, we expect to marginally increase our exposure within the emerging sector.

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Q: Considering PIMCO's forecast that inflation will fall back into the Fed's comfort zone, what is the firm's outlook for Treasury Inflation-Protected Securities (TIPS)?
Powers: The most important change is the recent underperformance of the TIPS market, bringing break-even inflation levels back to levels that are consistent with our inflation expectations going forward. Fed Chairman Bernanke is enamoured with the five-year forward, five-year TIPS break-even inflation rate as an indicator of inflation expectations. In May of this year, Bernanke became concerned about rising inflation expectations as represented by the five-year forward, five-year breakeven level in TIPS, but those levels have since moderated quite a bit.

Bernanke has noted the moderation in inflation expectations, partly due to the commodity price decline but also due to slower growth. With the Fed remaining in a restrictive posture and further signs of slowdown occurring—the Fed has acknowledged that the housing market is slowing down significantly—inflation expectations are likely to decline further. The market has already discounted low levels of inflation. Hence, we see value again in TIPS, especially in the front end of the TIPS market. We expect to increase our TIPS exposure opportunistically.

A second reason we find value in TIPS is the seasonality of inflation. Price increases tend to be implemented in the beginning part of the year. Thus, inflation trends higher in the first part of the year and then moves down from the middle part of the year towards the end of the year. Seasonally, we believe it makes sense to increase exposure to the TIPS market in the first six months of the year. 'Tis the season to be invested in TIPS!

Q: When we spoke in September, PIMCO was looking for opportunities to reduce its exposure to municipal bonds in the U.S. What is PIMCO's view on municipals following the December Forum?
Powers: The municipal market is fairly priced, especially on an after-tax basis, but is vulnerable to an interest rate rally should 10-year Treasury rates decline from the 4.60% level toward the 4% level, as we expect. As we saw the last time rates came down from 5% to 4%, retail investors and other non-tax-advantaged investors maintain a rate threshold where they begin to lose interest in munis. When rates drop toward 4%, investors' appetite for munis tends to wane versus other fixed income sectors. As crossover municipal investors, we are wary and expect that Treasuries will outperform munis in a falling rate environment. That should create an opportunity to buy munis once rates decline. For now, we expect that Treasuries, agencies and swaps—what we call "hard forms" of duration among fixed income instruments that tend to move first and fastest—will tend to outperform munis—one among other "soft forms" of duration—in a falling rate environment.

Q: PIMCO has been expecting the U.S. dollar to decline relative to other currencies, particularly versus the Japanese yen. What has happened with the dollar and what does PIMCO expect?
Powers: We affirmed our longer-term dollar underweight following the December Cyclical Forum. While there has been volatility in the dollar-yen, we have seen little progress in the dollar cheapening versus the yen.

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The yen has continued to cheapen on a purchasing-power-parity basis and policymakers in Japan have acknowledged the benefits of the overlooked yen to increase versus the dollar, the euro, the pound sterling and other currencies against which the yen has underperformed. Policymakers in Japan have mentioned that they have not intervened for three years and that they have a tolerance for a stronger yen-dollar relationship, perhaps at levels below ¥105, which is where they intervened aggressively last time. We have also noted some comments to the effect that policymakers think there have been negative externalities of low risk premiums that have been driven by the yen carry trade, which is the ability to borrow against a very cheap and underperforming yen and reinvest the money into risk propositions across the spectrum of the globe. In fact, policymakers have suggested that part of the benefit of normalizing rates on the front end of the Japanese yield curve would be to take the yen from an unnecessarily low level and put it back in line with parity among the world's currencies.

Betting that the yen will increase in value is obviously less risky for investors when Japanese policy rates are converging with other G7 central bank policy rates, but that has not recently been the case. In other words, it is very expensive to short the dollar at 5.25% or short U.K. sterling at 5% or to short the euro at 3.5% versus the 0.25% policy rate in Japan. Given our view that rate cuts by the Fed are more likely than an acceleration in the pace of tightening by the Bank of Japan, our expectation that the dollar will underperform the yen is driven by, and highly correlated with, our Fed call. Given limited prospects for an ease in ECB and MPC rates, it is possible that the euro and sterling will continue to outperform the yen.

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

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The Institute of Supply Management (ISM) Purchasing Managers Index, a manufacturing sector is based on five indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment. Prior to September 1, 2001, the acronym (PMI) was Purchasing Managers' Index. The PMI is sometimes referred to as the ISM index.

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