

Viewpoints

September 2009

Beyond Inventories and Fiscal Stimulus



Tony Crescenzi

Senior Vice President, Portfolio Manager

Tony Crescenzi is a senior vice president, market strategist and portfolio manager in the Newport Beach office. Prior to joining PIMCO in 2009, he was chief bond market strategist at Miller Tabak, where he worked for 23 years. He helped create that firm's asset management division and served as its chairman. Mr. Crescenzi has written three books, including his latest, *Investing from the Top Down*, which was published in 2008, and a 1,200-page revision to Marcia Stigum's classic, *The Money Market*. He taught in the executive MBA programme at Baruch College from 1999–2009. He has 26 years of investment experience and holds an MBA from St. John's University and an undergraduate degree from the City University of New York.

Trends in the financial markets in recent months have been rooted partly in the idea that the US and the world are experiencing a cyclical upturn in economic activity. Investor sentiment is being influenced in particular by data from the factory sector, which has improved mainly because in many industries production had fallen below sales. In other words, producers had cut production too much relative to demand and are now recalibrating their production levels to demand. This is boosting key data such as the Institute for Supply Management's monthly purchasing managers index and reducing the impetus to cut jobs. Ultimately, however, secular forces will restrain economic activity and limit the scope for extending recent trends in the financial markets.

Risk assets, including equities and corporate bonds, for example, have benefitted from the improved tone of economic data at the expense of US Treasuries. This is likely to continue until there is a break in the ever-improving tone of the data, although there are some signs that investors are already looking past the inventory cycle. It will take time before investors fully look past the inventory-led rebound, as there is momentum in the economy and data will look upbeat. For example, the new orders component of the ISM, which accounts for 30% of the index and is of course a leading indicator, reached 64.9 in August, its highest since December 2004. Numerous data are likely to improve in the time ahead as a result of the recalibration of production to demand, reinforcing recent market trends. Despite the pickup in growth, Treasury yields have fallen from their highs, possibly because investors are starting to look past the inventory story, as well as the impact of fiscal stimulus. For yields to rise, the embrace of the growth theme must take hold for longer.

For market trends in risk assets (including the stock market rally) to extend meaningfully, investors will require evidence that the inventory-led rebound in economic activity is evolving. There is no evidence of this just yet; the recovery is very fragile, like a small campfire that just can't get going because of the many winds surrounding it.

Three Major Constraints to Growth

While there is no doubt that the direction of change for the US economy is up, the magnitude of change is likely to be restrained by a number of factors, limiting ultimately the market response and the scope for risk assets to rally and for Treasury yields to rise. Three factors stand out:

1. Income growth
2. Wealth destruction
3. Credit availability

Viewpoints

September 2009

A fourth factor beginning late next year and in 2011 will be a sizeable fiscal drag, which will likely become a policy issue next year. Regulations on financial as well as on other industries – for example, higher capital requirements – pose additional challenges to growth.

Here are some notes on the above three points:

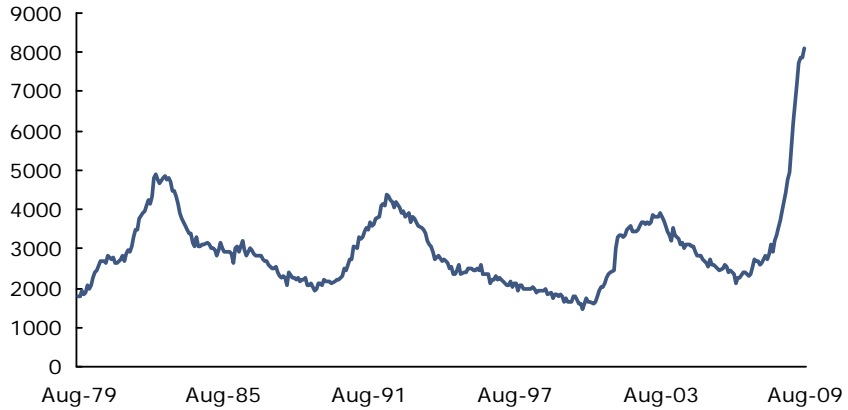
1. Many of the jobs lost during the recession are “permanent”, resulting from restructuring in many industries such as the finance and automobile industries (see Chart 1). This will restrain income growth both because job growth will likely be weak in any recovery and because the large pool of available workers will put downward pressure on wages. It took three years to recover all of the jobs lost during the past two recessions; it will probably take four to five years to recover the jobs lost during the current recession.
2. The recent rally in financial markets has restored some of the wealth households recently lost, but the magnitude of the loss has been much larger (see Chart 2). This should keep the savings rate on an upward path and restrain consumer spending. Remember the rule: for each dollar that wealth changes, spending changes by about four cents, studies show. The savings rate has thus far increased about what would be expected given the nearly \$15 trillion decline in wealth, meaning that there has yet to be a meaningful increase associated with the deleveraging impetus.
3. Credit is of course still difficult to obtain for both the household and business sector. This is evident in recent bank loan data, which as of August have shown no signs of improvement (see Chart 3 on commercial and industrial loans and Chart 4 on bank cash).

It is of course possible that endogenous factors related to the recent loosening of financial conditions combined with a revival of the “animal spirits” in the private sector could kindle more growth than seems likely. Moreover, innovation and efficiencies tend to evolve in periods of weak economic activity that could help propel growth in the time ahead. Continued growth in productivity also augurs well – it is a vital ingredient to improvements in the nation’s standard of living. Still, it will be difficult to overcome the numbers – in particular the mountain of public and private debt, and the sparse growth rate in incomes.

Viewpoints
September 2009

“Permanent” job losses have been unusually high:

Civilians Unemployed: Other Job Losers
As of August 2009, Seasonally Adjusted, Thousands

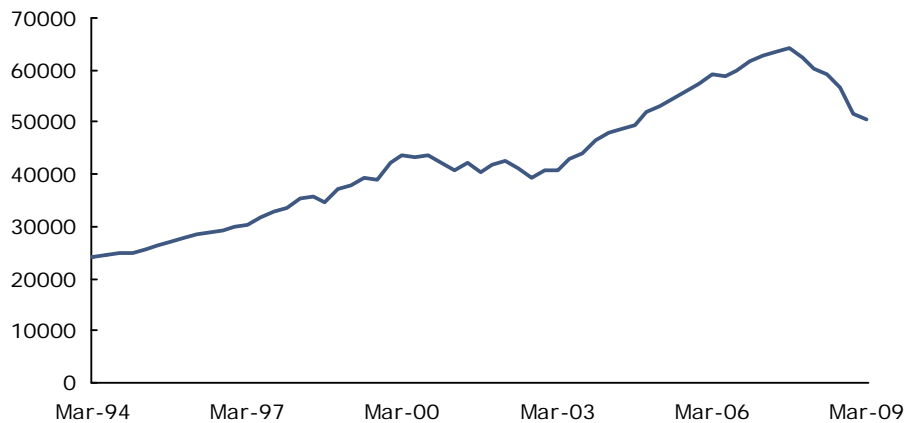


Sources: Bureau of Labor Statistics, Haver Analytics

Chart 1

Household net worth has plunged and is leading to a rise in the US savings rate:

Households and Nonprofit Organisations: Net Worth
As of March 2009, Not Seasonally Adjusted, USD Billions



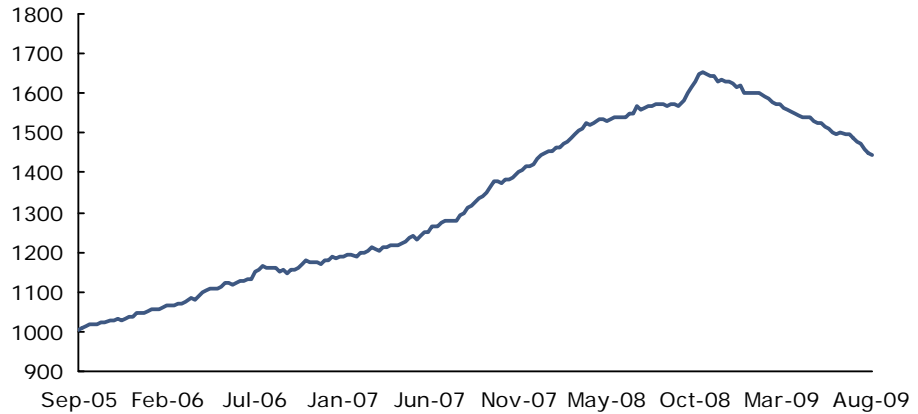
Sources: Federal Reserve, Haver Analytics

Chart 2

Viewpoints
September 2009

Commercial and industrial loans outstanding are still shrinking:

Commercial and Industrial Loans in Bank Credit: All Commercial Banks
As of August 2009, Seasonally Adjusted, USD Billions

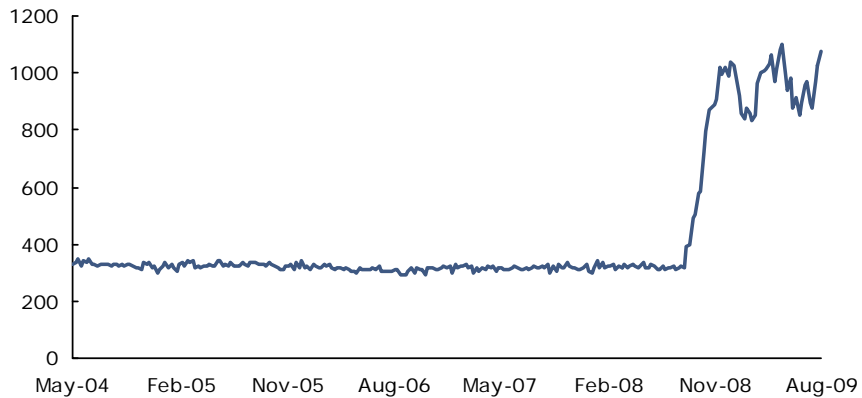


Sources: Federal Reserve, Haver Analytics

Chart 3

The velocity of money has plunged; banks are sitting on cash:

Cash Assets: All Commercial Banks
As of August 2009, Seasonally Adjusted, USD Billions



Sources: Federal Reserve, Haver Analytics

Chart 4

Viewpoints

September 2009

Singapore¹

PIMCO Asia Pte Ltd
501 Orchard Road #08-03
Wheelock Place
Singapore 238880
65-6491-8000
Registration No. 199804652K

Hong Kong²

PIMCO Asia Limited
24th Floor
Units 2403 & 2405
Nine Queen's Road Central
Hong Kong
852-3650-7700

¹ Regulated by the Monetary Authority of Singapore as a holder of a capital markets services license for fund management, and an exempt financial adviser. The services and products provided by PIMCO Asia Pte Ltd are available only to accredited investors, expert investors and institutional investors as defined in the Securities and Futures Act. The investment management services and products are not available to persons where provision of such services and products is unauthorized.

² Licensed by the Securities and Futures Commission for Types 1, 4 and 9 regulated activities under the Securities and Futures Ordinance ("SFO"). The services and products provided by PIMCO Asia Limited are available only to professional investors as defined in the SFO. The asset management services and investment products are not available to persons where provision of such services and products is unauthorized.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Certain US Government securities are backed by the full faith of the government, obligations of US Government agencies and authorities are supported by varying degrees but are generally not backed by the full faith of the US Government; portfolios that invest in such securities are not guaranteed and will fluctuate in value.

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. Outlook and strategies are subject to change without notice.

The ISM Purchasing Managers Index (ISM PMI) is a composite index that is based on five major indicators including: new orders, inventory levels, production, supplier deliveries, and the employment environment. Each indicator has a different weight and the data is adjusted for seasonal factors. The Association of Purchasing Managers surveys over 300 purchasing managers nationwide who represent 20 different industries. A PMI index over 50 indicates that manufacturing is expanding while anything below 50 means that the industry is contracting.

This material contains the opinions of the author but not necessarily those of PIMCO and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. ©2009, PIMCO.