

Spotlight

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Tomoya Masanao Discusses PIMCO's Secular Outlook for Japan

**Tomoya Masanao**

Executive Vice President

Mr. Masanao is an Executive Vice President, portfolio manager, and a member of PIMCO's international team. Mr. Masanao joined PIMCO in 2001, previously having been associated with Goldman Sachs Asset Management in London. He held the position of executive director/global fixed income and currency management, where he was a senior portfolio manager responsible for Japanese strategies. Prior to that, he was associated with Sumitomo Bank as a proprietary trader in London and a credit analyst in Osaka. Mr. Masanao has fifteen years of investment experience, and holds a bachelor's degree and a master's degree in engineering from Osaka University and an MBA from Boston University.

PIMCO's Secular Forum is an annual event we hold to discuss the long-term global outlook for economic growth and inflation. Each year, more than 100 of the firm's investment professionals gather to discuss globalization, geopolitical issues, demographics and other issues that can have a significant impact on global growth and inflation over the three to five-year secular timeframe. PIMCO also holds regular cyclical forums to discuss the shorter-term outlook, but the long-term Secular Outlook dominates the firm's investment philosophy and strategy. Following PIMCO's 2005 Secular Forum, we asked portfolio manager Tomoya Masanao to discuss the firm's key conclusions and the implications for the Japanese economy and bond market.

Q: PIMCO held its annual Secular Forum in May to discuss the global outlook for the next three to five years. What were the key conclusions from this year's forum?

Masanao: We came to two important conclusions at this year's Secular Forum. One conclusion is that low real interest rates will continue. Our second conclusion is that the balance of risks for the global economy is tilted more toward disinflation than reflation. What this means in terms of our investment outlook for the bond market is that we are in favor of high-quality nominal bonds, not just in the U.S., but globally.

Q: How has the firm's outlook changed since last year?

Masanao: One of the changes this time is that we believe low real interest rates will continue even longer than we thought at previous Secular Forums.

Another change in our secular outlook is our conclusion that the balance of risks is tilted more toward disinflation. In 2004, we believed the risks were balanced between reflation and disinflation, with a modest bias towards reflation due to massive reflationary efforts in the United States, China and Japan. These reflationary policies have produced strong economic growth globally but only 3% inflation in the United States, 2% inflation in Europe and 0% inflation in Japan. So we have changed our outlook based on the recognition that policy-induced reflation efforts have limits in terms of how much these policies can actually reflate the global economy.

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Q: Would you elaborate on the mechanisms that are keeping interest rates low and why PIMCO expects this to continue?

Masanao: The primary mechanism keeping interest rates low is the so-called “Bretton Woods II” arrangement, which is an informal policy arrangement where China explicitly pegs its currency to the U.S. dollar and other Asian countries including Japan maintain a de facto currency peg to the dollar.

Under this arrangement, Asia finances U.S. consumption at very low financing rates while offsetting insufficient domestic demand with U.S. demand for Asian exports. China, in particular, has strong incentives to do so to employ hundreds of millions of unemployed people. Asian countries also wanted to accumulate reserves, particularly after the Asian financial crisis of the late 1990s, and the Bretton Woods II arrangement has allowed these countries to build their reserves by exporting goods to the U.S.

To maintain their currency pegs versus the dollar, Asian central banks have been purchasing U.S. bonds, resulting in very low real interest rates, not just in the United States but globally. This arrangement has sustained an unsustainable imbalance in global aggregate demand, where demand is very much skewed to the United States.

Because of this imbalance in demand and the fact that Bretton Woods II is an informal arrangement in contrast to the formal Bretton Woods I arrangement, we have been concerned about the sustainability of Bretton Woods II. However, at the 2005 Secular Forum we concluded that Bretton Woods II is likely to continue at least for the next three to five years. China’s demographics give the government a strong incentive to continue the Bretton Woods II arrangement, because China’s main political and economic issue is how to employ hundreds of millions of people. The U.S. also has a strong incentive to continue this arrangement because reflationary policies have a limited ability to continue to stimulate and reflate the U.S. economy.

Q: Why did PIMCO conclude that U.S. policies have a limited ability to continue to reflate the U.S. economy?

Masanao: U.S. consumption has been driven primarily by asset price appreciation, notably in real estate markets that have benefited from these low real interest rates. However, there is a limit to how low real interest rates can go. For example, the real yield on a five-year Treasury inflation-linked bond is now about 1%, as opposed to 4% in 2000. So real interest rates have come down quite a bit and now have little room left to fall. The journey from 1% to 0% real rates will also be more difficult than the journey from 4% to 1% real rates.

Q: How are these changes in PIMCO’s secular outlook affecting the firm’s global investment strategy?

Masanao: In terms of our investment outlook, the combination of low real yields and low inflation would suggest we should favor high quality nominal bonds. This is true not just for the United States, but also for the other global markets, especially in Europe. In

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global portfolios, we would still favor European bonds slightly more than U.S. bonds, especially because Europe has structural weakness in its economy that should give Europe even lower economic growth and a lower inflation rate.

Q: Turning to Japan, what are the implications of PIMCO secular outlook for the Japanese economy?

Masanao: Japan also has strong incentives to keep this Bretton Woods II arrangement going and we believe these incentives will remain strong over our secular horizon. Japan's incentives for maintaining the Bretton Woods II arrangement have been its weak domestic banking sector, the 0% boundary on nominal policy rates, and the asset deflation over the last decade.

Those three factors have been very strong incentives for Japan to preserve this arrangement, but going forward we recognize that two of those incentives are weakening. The Japanese banking sector has improved and the asset deflation seems to be ending, particularly in the real estate markets in big cities. But we think that Japan is going to have another incentive to keep the Bretton Woods II arrangement afloat, which is its own demographics problem. With a total fertility rate of 1.28, Japan's total population will begin shrinking in 2007. That imminent problem should give Japan strong incentive to stay in the game because its reliance on external demand will continue to be very strong. Other developed nations face similar demographic issues, but the demographic problem presents more imminent risk in Japan than in any other developed country.

Another implication of our secular outlook for Japan is that fiscal policy tightening is very likely. Problems with retirement systems around the globe were a important topic at this year's Secular Forum, and we think Japan's future liability on its social security program is in serious shape, both in terms of size and speed of growth. Japan has already reached a point where future tax increases and discretionary spending cuts are inevitable. Fiscal policy tightening will remain a policy focus because Japan's goal is to achieve a balanced primary budget by 2010.

Another important implication for Japan is the inability to reflate the economy. As we all know, Japan has been running a 0% interest rate policy. This policy has worked reasonably well in bringing the inflation rate back to 0%, but Japan's inability to aggressively reflate the domestic economy has also been very evident, which leads to further reliance on Bretton Woods II and external demand.

Q: How are you positioning Japanese bond portfolios based on PIMCO's economic conclusions?

Masanao: There are three key themes we think are important in terms of our investment strategy in Japan. The first theme is the need for fiscal policy reform under deteriorating demographics, which means that monetary policy will need to remain subordinated to fiscal policy. In other words, with fiscal policy tightening, monetary policy will need to remain accommodative. This leads to our second theme, which is

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that the need for monetary policy to remain accommodative means low real interest rates will continue in Japan. The third key theme is that an increasing fiscal risk premium will need to be priced into the yield curve as demographics deteriorate and the social security liability increases as a result.

So in the fixed income market, this suggests JGB yields remain low and the yield curve remains steep. Over our secular horizon, we expect the yield on the 10-year JGB to range between 1% and 2%.

In our Japanese bond portfolios, we have been slightly underweight in duration versus the benchmark because of shorter-term cyclical developments, which include signs of momentum in Japan's domestic growth and the Bank of Japan's indications that they want to start normalizing short-term interest rates. On a secular basis, we will be closer to neutral on duration but we are being cautious about adding duration at these very low interest rate levels, and are looking for better levels to buy more JGBs. We are also focusing on the 10-year sector of the yield curve, to maximize returns from carry and roll-down, rather than the very short end or the very long end of the curve.

Q: Thank you.**Singapore**

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