

## Secular Forum

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### Bill Gross Discusses PIMCO's Secular Outlook and Strategy



**William H. Gross**

Managing Director and Chief Investment Officer

Bill Gross is a PIMCO founder, managing director and the firm's chief investment officer. He appears frequently in national publications and the media, and authors the monthly commentary Investment Outlook. Morningstar named him and his team 'Fixed-Income Manager of the Year' in 1998 and 2000 -- the first to receive the award more than once. He received the Bond Market Association Distinguished Service Award. Bill wrote the book *Everything You've Heard About Investing is Wrong*, and was subject of the book *The Bond King: Investment Secrets from PIMCO's Bill Gross*. He was the first portfolio manager inducted into the FIASI Hall of Fame for contributions to portfolio management and fixed-income analysis. Bill has 38 years of investment experience and holds a bachelor's degree from Duke University and an MBA from UCLA Graduate School of Business.

*Bill Gross is PIMCO's Chief Investment Officer, one of the firm's founders and the author of the monthly Investment Outlook. In the interview below, Mr. Gross discusses the outcome of PIMCO's Secular Forum, an annual event that brings the firm's investment professionals from around the world together to formulate the three to five-year outlook and investment strategy.*

**Q: PIMCO recently held its annual Secular Forum to discuss the outlook for the next three to five years. For those who may have missed your discussion of the secular outlook in the May/June *Investment Outlook*, would you give us a summary of PIMCO's main conclusions from the Forum?**

**Gross:** Over the next three to five years, our secular outlook suggests that global inflation, and certainly U.S. inflation, will accelerate mildly for a number of reasons. We also suggest that global growth continues rather strongly at a 4% to 5% pace, which is typical of what we're experiencing now.

That combination, I suppose, is not necessarily bond-friendly, especially in light of some of the changes that may take place in terms of financial flows—the recirculation of reserves from foreign central banks, et cetera. As a result, we've raised our forecast range for global interest rates, moving the range for 10-year U.S. Treasuries to 4.0-6.5% versus last year's forecast range of 4.0-5.5%, for instance, which is sort of indicative of how we see the bond markets in general.

In addition, in terms of major conclusions, we think that asset managers and bond managers, to the extent that they can, should try to take advantage of global growth via minor positions in emerging market currencies. We expect the U.S. dollar to be weak going forward, for a number of reasons. And we think that commodity prices in general, based upon this strong global growth environment and the demand from the BRICs<sup>1</sup> and the emerging market countries, will produce favourable results for commodities.

Those are our basic conclusions—not necessarily bond friendly but asset friendly in some ways, with the favoured assets being emerging market currencies and commodities in terms of some of the more applicable asset categories. We also think

<sup>1</sup> "BRICS" is an acronym referring to Brazil, Russia, India and China.

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that global stocks, especially those outside the United States, will benefit over this period of time.

### **Q: How has PIMCO's secular outlook changed compared to previous years?**

**Gross:** In terms of the history, PIMCO has been sort of a glass-half-empty type of manager for the past few years. We recognize global growth and the positive effects from it in terms of disinflation, in terms of high productivity and the positive effects from globalization and technology, financial innovation and favourable public policy positions, mostly related to free trade.

But at the same time, we thought that the world was relatively unstable. And in fact, it still is. But the glass-half-empty proposition took more account of that in terms of the debt positions of U.S. consumers, in terms of the U.S. trade deficit at 6% to 7% of GDP, and importantly, the lack of global aggregate demand, which still remains with us.

That's another way of saying that the U.S. is the world's only consumer, so to speak, and that potential consuming nations such as Asia and Japan and Europe are not really doing their part.

This lack of aggregate global demand has been a consideration for us in the past and remains with us. But nonetheless, we came to the conclusion this time that the glass is still half empty but it really is half full as well. And we also came to the conclusion that if we continue to see 4% to 5% global growth—admittedly with risks in a number of areas—perhaps this would exert some type of upward push in terms of inflation and ultimately in terms of interest rates.

That is the evolution and the change that has taken place this year in terms of our secular forecast, as opposed to last year.

### **Q: How has the global economy managed to grow at 4% to 5% with most of the developed economies growing well below that level?**

**Gross:** I suppose 4% to 5% global growth is not a well-advertised number with the United States growing at somewhere less than 2% now and Euroland a little bit above 2% and Japan below that level as well. But when you factor in China and India and the emerging market countries, the historic growth rate in the past few years has been in this 4% to 5% category.

Global growth has been a function of a number of things but certainly a function of emerging market nations benefiting from consumer demand in the United States and Euroland, as well as investment spending. Both of those factors have filtered into the global growth scenario that has produced 4% to 5% global growth.

### **Q: What role have financial flows played in sustaining global growth?**

**Gross:** Reserve nations such as China, with over \$1 trillion worth of dollar reserves and even countries such as Brazil at \$120 billion-plus and Japan of course, and petrodollar nations such as the Middle Eastern countries and Norway, have invested these monies back into the United States. And I think the evidence shows, for the most part, that these flows have subsidized yields and made a continuation of the global growth scenario possible by basically keeping the U.S. consumer alive. So, in addition

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to the positive effects on a global basis that emanated from globalization, this recycling of financial flows has been important as well.

**Q: Global inflation has remained relatively contained despite the strong growth in the global economy, but you said at the start that PIMCO expects a mild increase in inflation over the secular timeframe. Why is inflation likely to increase?**

**Gross:** To date, the primary benefit of globalization has been disinflation. Going forward, we see that changing a little bit and changing from a number of different angles. One angle is commodity prices, which we think will continue to maintain their bid and continue to favour headline inflation versus core inflation, which excludes food and energy prices and is what the Fed, at least, tends to focus on.

In other words, if commodity prices accelerate at a near double-digit type of rate from this point forward over the next three to five years, then ultimately that's going to have some type of effect on core inflation as well. Despite the fact that the U.S. tends to factor out commodity prices in terms of inflation calculations, ultimately that factors in.

Another major change is that the positive, disinflationary effects from Asia and other emerging markets will begin to wane as these labour forces are ultimately incorporated into the global economy over the next two to three years.

Other potential changes in the inflationary outlook could occur due to the ongoing battle between capital and labour. In the U.S., for example, the next election could result in policies that favour labour in the form of a higher minimum wage, which is in the process of now being raised a few dollars already.

All of these factors suggest to us that global inflation might be moving slightly higher over the next three to five years. We suggest an average rate of inflation in the United States of 3%, an average rate in Euroland of 2% and an average rate in Japan of about 1%. That's not dramatic but it is a mild change and a mild upward drift in terms of that inflationary outlook.

**Q: In terms of the investment implications of PIMCO's secular forecast, you mentioned earlier that this environment is not likely to be a favourable one for bonds. Could you elaborate on the reasons why?**

**Gross:** Our outlook for mildly higher inflation, in and of itself, suggests that bond yields will probably be marching slightly higher.

Secondly, we begin to sense a change in the financial flows that have helped to keep interest rates relatively low. You see it in the headlines every day, as do we, in terms of the beginning shift of policy changes on the part of major asset holders, whether they are central banks or petrodollar recyclers, or even financial innovators such as private equity and levered types of asset managers.

In effect, and we put this in the secular outlook, most investors these days are trying to be like Yale and Harvard now, which is fine I suppose, although it brings with it risks of its own in terms of leverage and ultimately compressing risk spreads to levels that are unattractive.

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But the race is on to be like Yale and Harvard now. And that to us suggests that purchases of safe, low-yielding assets—U.S. Treasuries, German bunds and other bonds—are likely to decline and flows into commodities and companies and equity-like types of investments will likely increase. We're not talking about a major overnight shift but at the margin.

Because of that, in addition to higher inflation, we sense a mild upward shift in what we've called the "subsidized yields" of global bond markets. The extent of the subsidy is difficult to prove, but one of the charts we included in the secular *Investment Outlook* suggests that global yields are and have been subsidized by as much as 50 to 75 basis points in terms of lower yields, based upon the willingness of the central banks to buy that safe U.S. Treasury bond.

To the extent that that stops at the margin—an example being China now investing \$3 billion in Blackstone, a private equity firm—we have to factor that into our equation in terms of the attractiveness of bonds.

So the bond market has several strikes against it. As inflation moves higher and as the subsidy disappears, those two strikes count against the bond market and move U.S. Treasuries to a slightly higher yield range—4% to 6.5% for 10-year Treasuries as I mentioned earlier.

### **Q: What are the implications of potentially higher bond yields for PIMCO's investment strategy over the long term?**

**Gross:** I want to emphasize first that this is a three to five-year forecast. It's not a three to five-month forecast and so the strategy implications of the Secular Forum really apply to the next several years rather than the next several months. Because of this, there is some contrast in the secular strategies versus our cyclical outlook for slower U.S. growth over the next several quarters and the Fed stopping its rate hike campaign at 5-1/4%.

In terms of secular strategy, this type of environment is not necessarily an attractive one for a typical bond manager. And PIMCO is primarily a bond manager, although we're trying to offer attractive rates of return as well and are moving and have moved into commodities and stock-index types of products and other strategies.

But for a bond manager, the secular environment we are describing suggests an end of the era of total return—though hopefully not our Total Return strategy—in which price appreciation and yield combined to produce near double-digit types of returns for the past 25 years, ever since 1981-82.

To the extent that trend reverses and price gains are no longer a part of the equation, at least in G7 types of markets, our strategy will be more defensive and we will need to reorient our positions going forward, not only in an effort to outperform indices, but in an effort to provide attractive returns as well.

We can't, however, be like Yale or Harvard. We can't invest in risky equity alternatives. Nor can we accept current risk spreads in the bond market, which in part are indicative

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of this trend to be like Yale and Harvard. So PIMCO is not making a sudden shift now from glass half empty to glass half full, from PIMCO to Yale. But at the same time, we have to recognize the implications that the financial markets may have for us going forward as a bond manager.

First of all, in terms of durations and maturity positions, the secular environment implies that portfolio durations would probably be less than market indices as opposed to greater than market indices. That is one of the biggest shifts that I would anticipate for the next three to five years. And after 25 years of being a bull market manager to all of a sudden become a bear market manager—although mildly so in terms of higher interest rates over the next three to five years—is sort of a major shift. But I think it is a well-deserved shift, at least based upon the forecast that we're suggesting.

Second of all, a bond manager must at least try to take advantage of this global growth, which we forecast at 5% going forward, while also recognizing the limitations of that statement and recognizing, as I've suggested, the narrowness of risk spreads in bond markets themselves. Credit markets, high yield markets, and volatility itself, all are compressed to near historic lows and suggest that at this point, taking major risk positions in order to be like Yale or a Harvard certainly wouldn't be justified.

It does not make sense for PIMCO to be buying even investment-grade corporates at 30 to 35 basis points over LIBOR. The spreads are too narrow and the risk of a cyclical correction is too great.

### **Q: Where does PIMCO see opportunity based on the secular outlook?**

**Gross:** We see opportunities in trying to take advantage of this global growth in several areas. One area we like is emerging market currencies, in part because of the potential weakness of the dollar, in part because of the strong growth of these economies themselves.

Countries like China, South Korea, and Singapore and others, and emerging markets in South America, such as Brazil, are all exhibiting strong growth. And to the extent that growth continues, then these countries' currencies should exhibit strong growth as well. In some cases the yields on these currencies are close to double digits, and I'd cite Brazil as the foremost example.

Nonetheless, a 5% position in emerging market currencies, to my way of thinking, does not take us out of bond land. But it does allow us to have an exposure and to potentially benefit from global growth that we see over the next three to four to five years. So we expect to have emerging market currency positions of 5% plus or minus, to the extent clients allow it, over the next several years. That's one way for a bond manager to participate without trying to mimic Yale and without accepting extremely compressed risk spreads, which are occurring at the moment.

We also believe some of these developing local bond markets still offer very attractive yields which stand the chance of going down as opposed to moving up, as we expect from the more developed markets. Here again I'd cite Brazil.

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And finally, global growth at 5% does in fact promote a positive push towards global commodities, whether it be oil or soybeans or anything else. And so we believe an allocation to commodities is quite attractive in this type of environment.

**Q: You alluded to the contrast between this secular outlook and PIMCO's cyclical views that the U.S. economy will slow and short-term U.S. rates are likely to decline. Have these cyclical views changed as a result of the Secular Forum?**

**Gross:** We recognize that this secular outlook may sound like just the reverse of our shorter-term cyclical view. But I want to emphasize that over the next 6 to 12 months we continue to see a weak U.S. economy, based upon housing, and we do see the Fed reducing rates in the latter part of 2007, based upon that weakness in the economy. None of that has changed.

Therefore, over the shorter term—and that being the first year, I suppose, of the next three to five years in terms of the secular outlook—we see a mild bull market as opposed to a bear market. That is how the two pieces of our outlook, cyclical and secular, fit together. They don't always correspond with each other in terms of bull-bull and bear-bear.

In this case we do like bond markets from this point forward for the next six months. But we do suggest in 2008, 2009 and 2010 that interest rates will be moving mildly higher and that less than index duration should be the consideration, as opposed to longer than index durations.

**Q: Thank you, Bill.**

### London

PIMCO Europe Ltd  
Nations House  
103 Wigmore Street  
London W1U 1QS  
England  
44-20-7872-1300

### Munich

PIMCO Europe Ltd Munich Branch  
Nymphenburger Straße 112-116  
80636 Munich  
Germany  
49-89-1221-90

### Amsterdam

PIMCO Europe Ltd Amsterdam Branch  
Schiphol Boulevard 315  
Tower A6  
1118 BJ Luchthaven Schiphol  
The Netherlands  
31-20-655-4710

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