

## Spotlight

January 2007

**Scott Mather Discusses PIMCO's European Outlook and Investment Strategy****Scott A. Mather**

Managing Director, Portfolio Manager

Mr. Mather is a Managing Director, member of PIMCO's Investment Committee and head of portfolio management Europe. He also manages euro and pan-European portfolios. In addition, he works closely with many Allianz related companies and is a Managing Director of Allianz Global Investors KAG. Previously, he co-headed PIMCO's mortgage and ABS team and managed portfolios of European Supranationals and U.S. agencies. Mr. Mather joined the firm in 1998, previously having been associated with Goldman Sachs in New York, where he was a fixed income trader specializing in a broad range of mortgage backed securities. He has thirteen years of investment experience and holds both a bachelor's and master's degree in engineering from the University of Pennsylvania, as well as a bachelor's degree in finance from The Wharton School of the University of Pennsylvania.

*PIMCO Managing Director Scott Mather is the head of portfolio management in Europe and a member of PIMCO's Investment Committee. In the interview below, Mr. Mather discusses PIMCO's latest views on the economic outlook for the euro zone and the U.K. following PIMCO's December Cyclical Forum and explains how these views are influencing the firm's European investment strategy.*

**Q: PIMCO professionals met at the December Cyclical Forum to develop the firm's 6-12 month outlook for the global economy and financial markets. What were some of the key areas that were discussed and how had they changed versus the prior Forum?**

**Mather:** At our prior Forum in September, we concluded that growth in the euro zone and U.K. will be quite vulnerable to a slowdown in U.S. growth. We still hold this belief, but we've been surprised at how resilient the European economy has been in the face of the dramatic slowdown we've seen so far in the U.S. In fact, the European economy has continued to improve by many measures, particularly in employment and confidence of businesses and consumers. That strength has come despite further confirmation of a housing-led U.S. slowdown and diminished expectations for U.S. growth in 2007.

Thus far, this incongruity between the U.S. and Europe is not unprecedented, but if we see it continue into the first quarter of 2007, it would start to look different than in other historical cycles. Given its composition of growth and its linkages to the rest of the world – through trade, financial market returns, direct investment and other things – Europe has historically always been impacted by U.S. slowdowns. There might be factors that lessen or increase the effect, but it is not typical to decouple completely.

At the Forum, we debated whether we're just seeing a bigger delay than usual in the impact of the U.S. slowdown, or if there is a greater decoupling than we've seen in the past as some economists are suggesting. We are not really convinced yet either way but rather think that we are seeing a little bit more of a decoupling than in previous cycles and take into account that there might simply be a bigger time lag in the cause

## Spotlight

January 2007

and effect relationship between U.S. and European growth. However, we strongly feel that the worse U.S. growth starts to look, the harder it will be for Europe to avoid the fallout.

**Q: What were PIMCO's main conclusions regarding the outlook for Europe following the Forum discussions? What are the primary risks to PIMCO's outlook?**

**Mather:** Given the resiliency of the euro zone economy we have seen so far, we expect 2007 growth in the euro area to come in the range of 1.75% to 2.25%, a slight increase from our forecast at the last Forum in September. Our inflation forecast for the euro zone has eased a bit, however, and we see 2007 core inflation at 1.5% to 2%.

We came away with the conclusion that the biggest risk in our outlook for the euro zone and the U.K. is closely tied to the risk of a hard landing in the U.S. A U.S. hard landing is not our base-case outlook, but we do see a higher probability of downside risk for the U.S. than we do see upside potential over the cyclical timeframe. If that risk becomes a reality, it would create a much greater slowdown in Europe than many people are anticipating. In that case, our current consensus-like forecast would be wrong, and we would certainly be counting on, and positioning for, interest rate cuts from the Bank of England's Monetary Policy Committee (MPC) and the European Central Bank (ECB) much sooner than the markets are currently priced for.

**Q: Looking at the euro zone first, what does PIMCO expect from the ECB in the base-case scenario?**

**Mather:** Our underlying view is that the ECB has become more data dependent. In the last policy meeting the ECB softened some of its rhetoric while still maintaining a hawkish stance, considering the unprecedented 3% increase of value added tax (VAT) in Germany at the beginning of January. The ECB will want to see how the German numbers look before their February meeting. They will also want to see how wage negotiations evolve at the beginning of the year and how new fiscal measures affect consumption. It's likely that they won't want to move until they have more clarity, so March is probably the next potential rate hike date.

But the expectation for a rate hike comes under the assumption that this time lag between the U.S. and euro zone economies will persist. We believe that the data could quickly start to slow in response to the U.S. slowdown and internal headwinds created through tighter monetary and fiscal policy. For example, it's unclear how strongly the VAT increase in Germany will impact overall consumption. So the statistical data will have a big influence on the ECB and its policy actions.

It has been our view that underlying inflationary pressures remain muted in Europe and are likely to stay that way. A quarter or two ago people were much more worried about headline inflation being in the mid-2% range and staying there, but we have been seeing the consensus forecast for inflation coming down. Energy prices have stabilised and economists are downgrading their assessment of where wage negotiations and pricing power are going to take inflation in 2007. So the market consensus is coming

## Spotlight

January 2007

more in line with PIMCO's views, and as that happens, the pressure is coming off the ECB.

### **Q: How are the dynamics within the euro zone affecting PIMCO's outlook?**

**Mather:** When formulating a European outlook, we can't ignore the substantial degree of decoupling within the euro zone itself. You have countries that are doing very well in export markets, like Germany, and then countries that are not doing so well, like Italy and France. Germany tends to draw most attention because it is the biggest economy but it is crucial to recognise that there are big differences in how growth is unfolding across the various countries within the euro zone.

German businesses remain much more confident than their French or Italian counterparts because their exports are doing well. Yet the weak link for Germany is still wages and the consumer. Even though German employment conditions have improved a bit, wage growth hasn't. France, meanwhile, has done a bit better on the wage front even though the French economy is lagging a bit, so consumer spending and domestic demand is a bit healthier than it is in Germany.

It's important to note these types of differences, because as we go through the cycle, we'll likely see further decoupling within the euro zone. Under these circumstances, watching the clues we get in each individual economy can help us clarify trends that may be lost in aggregate European statistics. This is particularly true because coming rounds of fiscal and monetary tightening will impact the various segments of the economy differently. Individual countries are exercising their fiscal tightening in different ways too, so there will be a lot of moving parts to watch that will affect the overall European outlook.

### **Q: What role will fiscal tightening play in the overall macroeconomic picture for the euro zone?**

**Mather:** Germany has the greatest amount of fiscal tightening slated with a 3% VAT increase. But there is also significant fiscal tightening in the new budget that was just passed in Italy, and you've got a little bit of tightening projected for France, though we'll get a better picture after the French presidential election in May.

The significant amount of fiscal tightening already announced dovetails with our view that the edge will be taken off growth and inflation in the euro zone. But quantifying the effect is difficult because we've never seen the euro zone move into a tighter fiscal and monetary regime in aggregate at the same time, at least not since introduction of the monetary union. Also it won't be simple to disentangle the domestic economic headwinds from external headwinds.

One thing that we have anticipated, and that appears to have unfolded, is the typical behaviour of consumers in which consumption is pulled forward ahead of a VAT increase. But there is a question about whether consumption will slow again in early 2007 because it is not clear exactly how much of the VAT increase businesses actually plan on pushing into prices. We have heard some reports that because of the high profitability at many German corporations, they'll be able to absorb some of the VAT

## Spotlight

January 2007

increase in their margins to keep sales up. If that is the case, you may not see the same big effect on consumer behaviour as you have with prior VAT tax increases.

### **Q: Now turning to the U.K., what is PIMCO's view on the U.K. economy?**

**Mather:** The U.K. economy has been very steady and you still have slightly above-trend growth. We've not seen the degree of upside surprise that we've seen in the euro zone, but U.K. growth has held up very well.

We observed some seemingly contradictory phenomena in the U.K. labour market where unemployment has been edging up in the U.K., but jobs are still being created. If you look at just unemployment, you'd suspect that there is some slack in the labour market. If you look at just job growth overall, you would expect that the labour market is running out of slack. These phenomena are happening because there has been massive growth in the labour force due to net migration, which has continued to surprise us and presumably everyone in the U.K., and due to older workers staying or rejoining the labour force. Similar to the euro zone, the healthy labour market hasn't necessarily led to much pricing power on the part of labour. With no significant inflationary consequences from the labour market and with the appearance of slack in the unemployment rate, the MPC will have a tough time justifying further tightening based on labour pressures.

Another concern for the MPC has been housing prices. Central banks don't like to talk much about housing but it is always a concern, especially when there are the type of price accelerations we have seen in the U.K. Depending on the measure you look at, home pricing has reaccelerated into that 8% to 10% area, which is higher than the mid-single digit percentage growth that we were thinking it would settle into at our September Forum. Even though the MPC hiked rates last August and November, bringing the overnight rate to 5%, it hasn't seemed to impact housing. That made us cautious since we anticipated a bigger slowdown to materialise more quickly than it has, given the circumstances. So, we felt that if U.K. housing stays resilient, the MPC would remain more confident to raise rates to 5.25%.

And indeed the MPC followed with a rate hike to 5.25% already in January. The statement of the MPC cited inflationary pressures as a reason for its latest monetary policy action, given that headline inflation came in at 3% for December and that the MPC expected the CPI to increase further. We have to remember that the stated inflation target of the MPC is at 2% and its mission is to maintain this target. Should headline inflation break above 3%, the MPC has to explain in a letter to the Chancellor why this happened and what actions they intend to take to reign inflation in. It would be the first letter in about ten years and clearly the MPC would want to avoid this.

Housing and other economic indicators will be very important for U.K. economy watchers and the MPC in the near term. However, we still hold the view that the MPC will need to cut rates later in the year, especially since the housing strength does not appear to be passing through to retail sales or other direct drivers of growth like it has in the past in both the U.S. and the U.K. We hold the view that headline will converge to core inflation over the course of the year. Core inflation has been well under the 2%

## Spotlight

January 2007

target of the MPC for some time. We expect the lagged effects of tighter monetary policy, slower growth, growing slack in the labour market, the fall in energy prices and the increase in the trade-weighted value of the pound to exert downward pressure on inflation, both headline and core. This will open up room for the MPC to cut rates later in the year.

### **Q: What types of strategies is PIMCO employing in portfolios to reflect its European outlook?**

**Mather:** In the euro zone, we have focused on positions that profit from a flattening in the yield curve. We continue to believe flatteners can be rewarding, largely based on our view that there is little inflationary pressure in the euro zone. There is less to be made on this trade going forward, since the markets have now priced in a lesser degree of inflation, but we still feel it has further to go. The ECB may continue its rate increases, which will likely flatten the euro zone yield curve further. But even if they don't hike rates, they will probably be hawkish for a while more, which will keep flattening pressure on the curve.

We have the opposite view in the U.K. The U.K. curve has become more inverted – nearing all-time record levels of inversion – and we believe it is likely to “dis-invert” to a more normal shape, partially based on our view that the MPC will likely cut rates in 2007. Of course, this view is highly dependent on our forecast for the U.S. because we would expect external economic developments, particularly a slowdown in the U.S., to have a bigger impact on the U.K. than the euro zone. So we believe the U.K. curve will steepen again, led by falling yields for shorter maturities. On the longer end of the U.K. curve, some of the technical pressure that kept yields low will be relieved as new supply of bonds comes to the market from both the government and corporations.

We haven't changed our view on corporate bonds. It is still true the corporate profits look quite good almost everywhere in the world. But pricing doesn't seem to reflect our base case scenario of a slowdown and therefore a gradual deterioration in corporate profits. Current pricing in the market leaves no room for error and no possibility for a hard landing in the U.S., so you've got to be a little more cautious.

### **Q: With the euro and sterling strong against both the dollar and the yen, will currency rates complicate things for the economy and for policymakers?**

**Mather:** The trade-weighted sterling and the trade-weighted euro are now close to their all time highs, with each up 3% to 5% over the past year. This is significant because for many parts of the economy it is equivalent to tightening monetary conditions 25 to 75 basis points. The extent of the tightening effect depends on which model you look at and what you choose to emphasise, but the point is that it has created a tightening of monetary conditions in addition to the ECB and BoE base rate hikes. We know that is something that the central banks have their eye on, although they have been careful not to raise this issue publicly yet. For example you're starting to see a lot of political pressure being exerted on the ECB by finance ministers and other government officials because it's hurting the export side of their economies.

## Spotlight

January 2007

There are policy implications from the strong European currencies. If we have further appreciation in the euro or sterling, it would give the central banks another reason to pause. We are approaching uncharted waters with the current levels and the ECB and BoE will want to determine the impact on trade and on inflation before they raise base rates much further. Raising rates typically strengthens currencies, which could exacerbate the problem.

PIMCO is generally maintaining an underweight in the U.S. dollar versus benchmarks, but in the absence of aggressive easing by the Fed, the scope for rapid gains in the euro or sterling should diminish once the ECB and BoE pause or start cutting rates.

### Q: Thank you, Scott.

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## Spotlight

January 2007

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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