

## Cyclical Forum

March 2007

### Paul McCulley Discusses PIMCO's Cyclical Outlook and Investment Strategy



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Mr. McCulley is a Managing Director, generalist portfolio manager, member of the investment committee and head of PIMCO's Short-Term Desk. He also leads PIMCO's Cyclical Economic Forum and is author of the monthly research publication *Global Central Bank Focus*. Mr. McCulley joined PIMCO in 1999, previously serving as Chief Economist for the Americas for UBS Warburg. During 1996-98, he was named to six seats on the Institutional Investor All-America Fixed Income Research team. He has twenty-two years of investment experience and holds a bachelor's degree from Grinnell College and an MBA from Columbia University Graduate School of Business.

*PIMCO Managing Director Paul McCulley leads the firm's quarterly Cyclical Economic Forums, in which our investment professionals from around the world gather to discuss the outlook for the global economy and financial markets over the next 12 months. In the following interview, Mr. McCulley discusses the results of the March Forum and its implications for PIMCO's investment strategy.*

#### **Q: PIMCO held its latest Cyclical Economic Forum in March. What were the key issues discussed in updating the firm's cyclical outlook?**

**McCulley:** The cyclical outlook continues to depend largely on the U.S. housing market, so the issues we explored at the March Forum were virtually identical to those we discussed at our previous Cyclical Forum in December. The key question, which remains to be answered, is how nasty the slowdown in the U.S. housing market will become, in terms of both prices and volume. Housing remains the key to our cyclical outlook because of the potential that the slowdown in the housing sector could spill over into the broader economy and impact consumption and employment.

The potential for a broader slowdown in the U.S. also raises questions at the global level. Does the rest of the world have enough internal demand to withstand slower residential investment demand growth in the U.S.? How quickly and how deeply will global inflation respond to a U.S.-led global growth deceleration? And how will central banks react, or react differently, in the face of slowing growth in the context of initial monetary conditions and sticky, lagging inflation?

#### **Q: If the issues influencing the cyclical outlook are largely the same as they were in December, has PIMCO's cyclical outlook changed following the March Forum?**

**McCulley:** While the questions were the same, our forecasts for growth and inflation are not the same coming out of the March Forum. We continue to look for a global soft landing as the most likely scenario based on expectations of continued slow growth in the U.S. and very mild contagion on non-U.S. growth. But our inflation forecast following the March Forum is materially lower compared to previous forecasts. We see less of a hint of stagflation in the cyclical outlook.

Looking at the numbers, we expect real GDP growth in the U.S. to range from 2% to 2.5%, up from the previous range of 1.75% to 2.25% in December, and we lowered our

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forecast for core inflation in the U.S., which we expect to range from 1.75% to 2.25%, down from the previous range of 2% to 2.5% in December. In Europe, we expect real GDP growth to range from 2.25% to 2.75%, which is up from the December range of 1.75% to 2.25%, while our core inflation forecast is unchanged at 1.5% to 2%. For Japan, we left our growth forecast unchanged at 1.75% to 2.25% for real GDP but dropped our core inflation forecast to a range of -0.5% to 0%, down from the December range of 0% to 0.5%.

Overall, this scenario, on first blush, would imply that central bankers get to do what they really want to do over our cyclical horizon: the Fed sits on hold, neither hiking nor cutting; the European Central Bank hikes one more time, with a remote risk of a second hike; and the Bank of Japan hikes, at most, one time more this year. From an investment perspective, this scenario also implies a downward tilt to the U.S. dollar.

**Q: Following PIMCO's December Forum, you noted that the U.S. housing market continued to slow but that employment was holding up relatively well. Has anything changed in terms of the housing market or the potential for a housing spillover into employment and consumption?**

**McCulley:** The new information we reviewed at the March Forum was the fact that the sub-prime mortgage market has been revealed to be a cesspool of irrational underwriting standards. We've long known this, but now the world knows, and lenders are tightening the underwriting terms for sub-prime borrowers as a result.

As Bill Powers noted at the Forum, there are three key factors in gauging troubled waters in the property market: long-term interest rates, the state of the job market, and the availability of credit. Right now, two of the three are very, very positive, while the third is turning very, very nasty.

What is the net effect? First-time homebuyers have driven the home ownership rate to record highs and fuelled accelerating home price appreciation in the process. So I believe that reduced availability of credit for first-time homebuyers and other sub-prime borrowers will, in the fullness of time, dominate. But when will time be full? We don't know.

What we do know is that job creation will be the key variable influencing the Fed's rate decisions. We also know that no rational person can conclude anything other than that the popping of the property market bubble will ultimately have a negative impact on job creation, both directly and indirectly.

**Q: Why is the tightening in mortgage lending standards such a dominant factor in the cyclical outlook if the tightening is confined to those with the weakest credit?**

**McCulley:** From an investment perspective, the decisive question for the cyclical outlook is whether the recognition of risk in the sub-prime market will lead to a repricing of risk elsewhere. If you have one asset class that is infected with irrational exuberance, you could very well have others, so you have got to think in terms of the contagion effect from the investment side and then you have to think about what that

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means for the real economy. And from a macroeconomic perspective, the key question is whether the repricing of risk elsewhere, if it happens, will have a material effect on global aggregate demand, and therefore the real economy. From a monetary policy standpoint, the Fed and other central banks are not that worried about a repricing of mispriced risk, but they will become concerned if the repricing has a profound effect on the macroeconomic outlook. The Fed does not want to respond to a repricing of risk unless they have to due to contagion in the real economy.

### **Q: Why might the tightening of credit in the sub-prime market have a contagion effect?**

**McCulley:** A tightening of underwriting terms is an intensely corrosive factor to leverage-fuelled asset appreciation. Levered animal spirits are the stuff of boom, and when bankers tighten lending standards to levered speculators, liquidity becomes a mirage.

At the end of the day, liquidity isn't about money stock growth, but a risk-seeking state of mind. In other words, liquidity isn't about money on the sidelines per se, but rather about the risk appetite of those on the sidelines. And when risk appetite turns, no amount of liquidity on the sidelines matters, particularly when a crowd gathers there. This is the essence of modern day finance. The human condition is, in the end, momentum-driven, not value-driven.

### **Q: Slower growth in the U.S. has, so far, had little effect on the European economy. What is driving the growth in Europe?**

**McCulley:** The euro zone economy feels like it is booming, though we need to remember that Europe really is a low-volatility region when it comes to growth. Euro zone growth tends to range from 1.5% to 2.5%, with growth at the top of that zone seen as robust and growth at the bottom of that zone leading to gnashing of teeth. The reason growth is near the top of the zone right now is sturdy business confidence, manifest in robust capital spending, notably in Germany.

The question is why the euro zone is seeing an investment boom when domestic consumer demand is so lacklustre. We debated a number of explanations at the March Forum, but foremost was the thesis that European corporations—notably in Germany—have robust cash flow as a result of shafting labour for many years, and are using that cash to refresh, replenish and restore aging equipment. According to this thesis, a lot of stuff in Europe is simply worn out.

I'm not sure I buy this; but who am I to say? Facts are facts, and domestic business investment in the euro zone is robust. For me, the best "explanation", as many at the Forum espoused, is a supply-side revolution, borne of ever-widening integration in the euro zone. Simply put, Old Europe corporations must invest to keep up with the low-wage-cost New Europe.

The bottom line on Europe is that we reaffirmed our sturdy growth outlook and we are a bit more benign in terms of our outlook on the inflation side.

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### **Q: Like Europe, Japan is also experiencing an investment boom. Are the same factors driving domestic investment in Japan?**

**McCulley:** We are somewhat perplexed by the robust domestic investment in Japan in the face of, at best, mediocre growth in domestic consumption and very restrained growth in real wages. Are there domestic production constraints in the aftermath of “under-investment” in domestic capacity during the fifteen years of debt-deflation, which destroyed capitalist animal spirits? We really don’t know for sure, but it is a fact that Japanese mega-industrialists are investing at home, which is rather compelling evidence that the domestic capital stock has atrophied, as well as become less than cutting edge on the technology front. It could well be the case that intellectual property rights, not fulsomely respected in China, have reminded Japanese industrialists that sometimes the really cutting-edge production technologies need to be kept at home.

The bottom line is that Japan is doing rather nicely, despite soggy consumer income and spending growth. That is not the stuff of internally driven growth, so we see Japan for what it is, but we worry about it.

### **Q: What is PIMCO’s view on China?**

**McCulley:** The China juggernaut has powerful momentum, but at the margin, the most recent data suggest a very modest deceleration. More importantly, perhaps, the Chinese leadership recognizes that the current state of growth affairs, while glorious, is also very problematic. Maldistribution of investment is a growing problem for China’s capitalist ambitions and the increasingly massive income inequality in China is creating social instability. Chinese political leaders recognize this, even as they must cling to mercantilist development policies, for nothing is as important as job creation. Much will remain the same in China, but change will become ever more evident. The Chinese leadership understands that success breeds success, but also breeds hubris, which is corrosive to social order.

The new Chinese Five-Year Plan, which, among other goals, seeks more balance between investment and consumption, is more important on a secular horizon, but is not irrelevant on a cyclical horizon. The Communist Party embraces capitalistic risk-taking. But there is a limit! China remains a command economy, even as it becomes a capitalistic economy. The pursuit of profit is admired, but the pursuit of profit is not immune to the “needs” of the communist state.

At the March Forum, we debated whether, over the cyclical horizon, China will be able to control its economy with restrictive administrative tools or reach a tipping point, when it will be “forced” to unleash its currency to global market forces. This is a key question for which there is no right answer, only probabilistic answers.

### **Q: Aside from China, has PIMCO’s view on the emerging markets changed at all following the March Forum?**

**McCulley:** Our view on the emerging markets is much as it’s been for a long time. Emerging market countries, as a block, are enjoying improving domestic fundamentals and institutions, large stocks of self-insurance in the form of reserves, and the joy of

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riding a positive terms-of-trade shock from the rise in commodity prices. To be sure, the story isn't uniformly positive; there are differences. But in general terms, the risk of contagion in emerging markets due to decelerating growth in the U.S. is much, much less than has historically been the case. That does not mean emerging market countries will not feel the effects of a U.S. slowdown; they certainly will, particularly if commodity prices retreat. But the secular improvement in emerging market fundamentals will cushion the impact in a very material way. Simply put, emerging markets in aggregate are not going to experience another crisis like 1997-1998 because emerging market countries never want to go there again and have taken appropriate steps to prevent that outcome.

At the same time, over our cyclical horizon, emerging market countries are unlikely to be an independent source of global aggregate demand growth. Over the secular timeframe and beyond, these countries will mature and morph from mass producers to mass producers who are also massive consumers. But we do not see this occurring over the cyclical timeframe.

### **Q: How are the conclusions from the March Forum influencing PIMCO's global investment strategy?**

**McCulley:** To sum up our outlook following the March Forum, we are looking for a global soft landing, with some degree of decoupling of growth across the regions and with generalized, modest disinflation. We are also looking for convergence in global monetary policy, as the Fed reverses to easing and the rest of the world brings tightening campaigns to a close, going on protracted hold, even if not joining the Fed in reversing policy. That configuration implies weakness for the dollar, perhaps quite precipitous at times.

More broadly, it remains a risk-management world, both for global central bankers and PIMCO. A global soft landing is the most likely scenario, but the predominant alternative is a harder landing, led by the United States, as the rot in mortgage finance smells up the joint, infecting other sectors, notably consumer spending. That doesn't happen very often, and it is never wise to bet against the U.S. consumer for very long. But never has the U.S. consumer been so broadly levered to an overvalued asset like the U.S. property market, on the back of Ponzi financing schemes<sup>1</sup>.

### **Q: Thank you, Paul. We look forward to speaking with you again following PIMCO's annual Secular Forum in May.**

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<sup>1</sup> For more on Ponzi financing schemes in the U.S. housing market, see Paul McCulley's March 2007 *Global Central Bank Focus*, "The Plankton Theory Meets Minsky", on [www.pimco.com](http://www.pimco.com).

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