

## Spotlight

June 2007

**William C. Powers Discusses PIMCO's Secular Outlook and Global Strategy****William C. Powers**

Managing Director and Senior Member of PIMCO's Portfolio Management and Investment Strategy Groups

Mr. Powers joined the firm in 1991, previously having been associated with Salomon Brothers, and with Bear Stearns as senior managing director, specializing in mortgage-backed securities. Mr. Powers has 22 years of investment experience, and holds a bachelor's degree in economics from Princeton University and an MBA from Stanford Graduate School of Business.

*Bill Powers is a senior member of PIMCO's Portfolio Management and Investment Strategy groups, and plays a key role in formulating the firm-wide viewpoints that shape every PIMCO portfolio. These views are guided by PIMCO's cyclical Economic Forums, which examine the outlook for the next six to 12 months, and the annual Secular Forum, which focuses on the three-to-five year outlook. Bill Gross recently discussed the major conclusions from PIMCO's annual Secular Forum, and in the interview below, Mr. Powers discusses the details of the firm's global outlook and investment strategy following the Secular Forum.*

**Q: PIMCO recently held its annual Secular Forum to formulate the firm's global outlook and strategy over the next three to five years. Would you give us an overview of the main conclusions from the Forum?**

**Powers:** One of the key conclusions from our Secular Forum is that some of the effects of globalization that have kept bond yields low and helped to contain inflation in recent years are likely to wane over the next three to five years.

One effect of globalization is that China, India and other low-cost producers in the global economy have been able to grow at a much faster rate than the developed economies. As a result, global growth has been strong overall, running at about 5%, despite much slower growth in most developed economies. Strong global growth has not led to rising inflation due to the disinflationary influence of developing economies exporting cheap products. We see this dynamic changing over the secular timeframe. Global growth will remain strong, concentrated in the developing economies, but China, India and other developing economies are facing cost increases that will reduce the disinflationary influences of globalization. Rising commodity prices will be one source of increasing costs as strong growth and investment sustain global demand for raw materials. Another is the diminishing returns from the cumulative effects of bringing new entrants into their workforce. Hence, we expect the disinflationary benefits of globalization will wane and continued strong growth will lead to modestly higher inflation over the secular timeframe.

Another effect of globalization is that China and other developing economies, as well as the oil producers, have amassed huge pools of money from exports. These reserve funds have invested primarily in U.S. Treasuries and high-quality fixed income to prevent their currencies from appreciating versus the U.S. dollar, sustaining demand for exports, particularly in the U.S. This dynamic has subsidized U.S. rates but is also likely to change over the secular timeframe. Developing economies will continue to

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accumulate surplus reserves, but are beginning to diversify away from bonds into equity and other higher returning asset classes, including commodities and real estate. These segregated pools of reserves targeting riskier, higher-returning assets are known as “Sovereign Wealth Funds”.

**Q: Where does PIMCO see the greatest potential for bond investors to profit from these global trends over the secular timeframe?**

**Powers:** We see very attractive opportunities in the emerging markets based on our expectation that current global growth trends will continue. We also see opportunities to potentially profit from a secular decline in the U.S. dollar.

In an environment where developing countries are growing well above 5% and mature economies are growing at rates of 2%-plus, assets in developing countries will likely remain more attractive than assets in developed countries. We believe the greatest value is in emerging market currencies, which stand to benefit from the strong growth in these countries, and in bonds issued locally in developing markets, which offer attractive yields and more potential for capital gains than dollar-denominated emerging market bonds.

**Q: Which currencies offer the greatest potential for appreciation based on PIMCO’s secular outlook and the firm’s forecast of a secular decline in the U.S. dollar?**

**Powers:** We see particular opportunity in emerging currencies versus the U.S. dollar given our conclusion that sovereign wealth funds are nearing a saturation point in their accumulation of dollar-denominated bonds, in addition to the reasons mentioned in your last question.

Appreciation in China’s currency, the RMB, in a jump-shift regime change runs counter to the top priority of the Chinese leadership due to the importance of maintaining a favourable exchange rate in order to accommodate the migration of 25 million peasants each year looking to join the newly industrialized economy. Tensions due to the high and rising U.S. current account deficit and protectionist threats from the U.S. Congress will at a minimum keep China committed to a path of longer-term currency appreciation and currency flexibility.

This slow and steady path is unlikely to provide externalities to support a similar appreciation of the Japanese yen. Prospects for yen strengthening remain tied to prospects for global risk aversion through a threat to the continuity of harmonious global expansion. For this reason, PIMCO remains wary of yen/dollar positions.

More likely beneficiaries of PIMCO’s bearish secular dollar forecast are the emerging market currencies targeted in PIMCO’s basket of emerging currencies, which includes the Brazilian real, Russian ruble, Mexican peso, Korean won, Singapore dollar and Polish zloty. China’s RMB, the South African rand, the Malaysian ringgit and the Indonesian rupiah may join the EM basket as we progress into the secular horizon.

In G-10 space, the tightening of monetary policy, upgraded economic rating, and preference among petrol surplus countries versus the dollar favour the euro. Australian real rates and the allure of commodity-based currencies should favour Australia.

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Canada, despite its commodity contribution and tightening policy, remains linked to the dollar through trade dependency, limiting its upside from current levels close to parity. The British pound appears stretched as well at current levels of close to two-to-one versus the dollar.

**Q: You have often discussed the need for caution when it comes to currency exposure in a bond portfolio. Why is PIMCO more comfortable with emerging market currency exposure, and bonds denominated in emerging market currencies, as a potential source of alpha in a core bond portfolio?**

**Powers:** First and foremost, we see value in these assets. Many of these emerging countries are maintaining some of the highest real rates in the sovereign investment world, with improving credit quality and the potential for capital gains based on expectations for a prolonged series of rate cuts ahead and rates declining consistent with continuity of financial discipline, which warrants lower real rates in their domestic bond markets. In these markets, domestic inflation rates are already modest and stable, especially by historical standards.

The emerging markets are clearly not the same markets they once were, with more than half of the issuers in this market now in the investment-grade universe. These countries have been extremely disciplined in their determination to avoid the episodes that occurred in the past where a lack of reserves, a lack of fiscal discipline, and an abundance of dollar-denominated debt and pegged or uncertain currency regimes led to financial distress, often catalyzed by business cycle risk in the U.S.

One prime example of this determination to avoid the past is that emerging market issuers have maintained fiscal discipline despite having what many would consider reserves far beyond what might be needed as a cushion against economic cycles. This stands in marked contrast to many corporate issuers that are releveraging their balance sheets and engaging in merger and acquisition activity and stock buybacks after a few years of repairing their balance sheets and profits.

Another reason we are comfortable with emerging market currencies and local market bonds is that many of these countries have been able to retire their dollar-denominated debt and increasingly rely on local currency debt to fill out their own yield curves as a preferred means of financing. This market is much bigger today, particularly when you factor in the growth of derivatives, which have provided increased liquidity to many other sectors of the market and allowed investors to enjoy greater choices.

**Q: Given the secular outlook, does PIMCO still see opportunity in the short end of the U.S. yield curve as you've discussed following the firm's recent Cyclical Forums?**

**Powers:** Yes, we believe there is room for one last bond market rally that would favour the short end of the U.S. yield curve over the next 12 months. Global rates have recently risen significantly, recognizing some of the secular trends that we have identified. We think that trend is likely to persist over much of our secular timeframe. However, there are some cyclical influences that are still playing themselves out, particularly in the U.S. where the long and slow path of adjustment from the housing bubble in volume and price terms and the effect on the consumer and the U.S. economy have largely not played themselves out yet.

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Forecasters at the Fed, as well as economists, believe the economy has successfully moved through a V-shaped, housing-induced and inventory-induced slowdown into enduring growth on the other side. We continue to question that view. The enormous adjustment in terms of higher rates will likely make the housing situation worse, requiring the Fed to make adjustments to accommodate what will be a more severe housing slowdown than is now discounted by the market.

Favouring the short end is also consistent with our secular outlook because any cyclical rally in 10-year rates will likely be more muted, and over the secular timeframe, we expect term premiums to normalize as modestly higher inflation pressures and rising real rates lead to higher rates in the long end. Over our secular timeframe, we expect 10-year U.S. Treasury yields to range from 4.5% to 6.5%, which is up from last year's secular forecast range of 4% to 5.5%. Hence, PIMCO is secularly bearish, but with a slightly bullish cyclical outlook that continues to focus on the front-end of the U.S. curve.

### **Q: Why would the Fed consider cutting interest rates when it seems there is ample liquidity in the financial system?**

**Powers:** It is true that corporations and levered investors are enjoying outstanding liquidity at what they find to be reasonable rates and credit spreads. Corporations are using this access to capital and the very narrow spreads in corporate bonds as fuel for equity buybacks and merger and acquisition activity. Private equity and hedge funds are using this liquidity to take large, levered positions. Hence, these market participants would likely characterize current financial conditions as being somewhat stimulative.

However, this is at odds with the highly indebted man on the street who is considering a new home purchase, or worse, having to give up a low rate on a hybrid adjustable-rate mortgage to reset at a higher rate and therefore finance his home at a much higher rate. From that perspective, we think current rates are very restrictive.

### **Q: How would you compare PIMCO's current secular outlook with the firm's secular views in previous years?**

**Powers:** Last year, the secular outlook was driven by the risk of a bear market in housing leading to lower mortgage equity withdrawals and consumer confidence as well as adjustments in employment levels for housing-related sectors. With the view that global growth was still primarily dependent on the U.S. consumer, we felt that the effects of a U.S. slowdown driven by a housing adjustment would cause a global slowdown, creating the risk of a recession some time over our three to five-year outlook.

This year the framework is quite different. This year we see global growth enduring outside the United States, with re-ratings of potential growth in both emerging and developed economies including Europe, the U.K. and Japan. The expected speed limit of the global economy is now somewhat higher and we see the U.S. now as a beneficiary of this global growth. The cyclical risks of U.S. imbalances, including the housing market, have been rated down as a result of the liquidity, wealth and growth coming from other regions of the world.

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Thus, rather than the U.S. being at the centre of the storm, if you will, and those economies that are dependent on the U.S. at risk, we now see the U.S. as moving out from the centre towards the periphery of some very strong global effects that are very long term in nature.

**Q: Based on the changes in the secular outlook, as well as the cyclical factors discussed earlier, what is PIMCO's investment strategy?**

**Powers:** Based on our cyclical outlook, we remain slightly overweight in duration versus our benchmarks. As our cyclical outlook is affirmed, we expect to reduce that overweight to an index duration and eventually to below-benchmark durations over the secular timeframe.

Elsewhere, the Bank of England and European Central Bank (ECB) continue to raise rates. The ECB has now raised rates to 4% and the market is now discounting 4.5%. The ECB is a leading candidate among central banks to exceed the tightening now discounted by the market given the ECB's single mandate of keeping inflation below 2% and revisions rating European growth stronger. While the European housing market has slowed, a combination of credit creation in Europe and wealth from global GDP growth externalities has created an enormous amount of liquidity that fuels European growth. That liquidity enhances the prospect of continued growth in Europe and the potential for inflation risks that may prompt the ECB to raise rates above 4.5%. Hence, we are currently more wary of policy pressures on rates in Europe than in either the U.S. or the U.K. However, over the longer term, we may favour European duration due to its lower volatility in a rising rate environment and because of the inflation vigilance due to the ECB's single mandate to keep inflation below 2%. Part of our expectation for higher rates in the U.S. is that the Fed may need to accept a higher inflation rate than would be accepted by the ECB.

We also believe Japan could be a more attractive environment for fixed income over the secular timeframe due to its demographics, the proximity to Asian disinflationary forces and the very slow pace of policy normalization by the Bank of Japan. Given the demographics in Japan and the lower speed limit for the Japanese economy, we see little inflationary threat in Japan. Hence, with Japanese 10-year yields currently around 1.9%, we think that 3% represents a generous discounting of the likelihood of where 10-year rates could travel over the secular horizon. Our secular forecast for Japan 10-year rates is 1.5% to 3%

Turning to Australia, the yield curve is very flat at rates well above 6%. Front-end rates one year from now are priced at about 6.75%, which seems a fair level to us. Hence, we think the front end of the Australian market offers value.

**Q: Turning to specific sectors of the fixed income market, how is the secular outlook influencing PIMCO's view of mortgage-backed securities?**

**Powers:** We are currently a bit concerned about the mortgage market based on the low volatility premium priced into mortgages. A rising rate environment also creates extension risk in mortgages. The duration of mortgage securities increases as mortgage prepayments and housing market turnover decline. Given unusually high housing turnover in the recent U.S. housing boom, the market may be similarly surprised by extension risk in a rising rate environment as housing turnover slows,

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perhaps dramatically. We expect mortgages to become more attractive in the future as rates rise and curves steepen with the return of term premiums, and when there are disruptions in the market caused by mortgage servicers attempting to hedge their exposure.

**Q: Given the likelihood of higher inflation over the secular timeframe, does PIMCO see value in inflation-linked bonds such as U.S. TIPS?**

**Powers:** We typically favour TIPS and other inflation-linked bonds in rising rate environments because these instruments tend to be less volatile than Treasuries. A risk to TIPS has been the limits on rising inflation expectations due to market confidence in the vigilance of central banks to counter inflation expectations. But going forward, especially in the latter years of our secular horizon and primarily in the U.S., some of this anti-inflation rigor may need to give way with the Fed tolerating higher core inflation (which excludes food and energy prices). The new risk to TIPS comes from the prospect for rising real rates, a departure from recent PIMCO Secular Forums. Given the assumptions for continuing relatively high return prospects in other asset classes, we believe a move in U.S. real rates, from 2.5% to perhaps 3.5%, could account for a significant part of the potential rise in nominal 10-year rates. Hence, despite forecasting higher rates in our secular horizon, we are cautious on TIPS.

**Q: What is PIMCO's view of corporate bonds? Is a secular environment of strong global growth reason to increase PIMCO's exposure to the corporate sector?**

**Powers:** We still see very limited opportunity for further tightening in corporate bond spreads. With much of the good news from enduring global growth already reflected in current spreads, and with relatively high recent historical profit levels peaking, the corporate bond market's best years may be behind it.

Areas where we continue to find value in the corporate sector are those that have higher prospects for upgrades versus downgrades. One of those areas is energy and pipelines. Others include emerging corporate names. We remain very mindful of the potential for event risk in some issuers, including merger and acquisition or leveraged buyout targets.

**Q: Thank you, Bill. We look forward to speaking with you again after PIMCO's next Cyclical Forum in September.**

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