

## Q&A

July 2007

### Rob Mead Discusses PIMCO's Secular Outlook and its Implications for the Australian Economy and Markets



**Robert Mead, CFA**  
Executive Vice President

Mr. Mead is an Executive Vice President, Head of Portfolio Management for PIMCO Australia and Head of Asia-Pacific Credit Portfolio Management. Prior to joining the Sydney office he was a Portfolio Manager for PIMCO Fixed Income Portfolio Management in Munich and Head of the European Investment Grade Corporates team. Mr. Mead joined the group in 2003, previously having been associated with Citigroup Asset Management in London as Global Head of Investment Grade Credit Research and Head of non-US High Grade Fund Management. Mr. Mead was responsible for all Sterling and Euro investment grade corporates, as well as the credit component of global mandates. Previously, he worked as a Corporate Bond Fund Manager for JP Morgan Investment Management in Melbourne, where he built a local corporate bond portfolio presence. Mr. Mead has nineteen years of investment experience and holds a Bachelor's degree in Business from the University of Technology, Sydney, a Graduate Diploma in Applied Finance from the Securities Institute of Australia and is a member of the New York Society of Securities Analysts.

*PIMCO's Secular Outlook for continued global growth will have implications for commodity prices, currencies and global credit markets. In the interview below, Portfolio Manager Rob Mead discusses how PIMCO's outlook for global economic developments will impact the firm's Australian outlook and strategy.*

**Q: PIMCO's philosophy is founded on the idea that secular economic, social and political trends will exert the most powerful and sustained influences on bond markets. Following the firm's recent Secular Forum, what were the biggest changes in PIMCO's outlook since last year?**

**Mead:** A key change from our secular outlook from one year ago is an acknowledgement of a greater degree of resilience in the global economy, particularly outside the U.S. The contribution to global gross domestic product growth in the developing world has been in the 5%-plus range while the U.S. and other mature countries have grown in the region of 2%.

Within the U.S., consumers have been facing headwinds from the housing market, which is coming off its peak, and from the once very popular financially-engineered mortgages being refinanced at higher levels as a result of the 17 Federal Reserve rate hikes since June 2004.

So the key message from our Secular Forum is that global growth is expected to remain more robust, and as a result we have raised our forecast for interest rates over the next three to five years. The three- to five-year forecast for 10-year U.S Treasury yields has increased from a range of 4.0% to 5.5% last year to a range of 4.5% to 6.5%.

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**Q: What is Australia's role in the global growth story?**

**Mead:** Australia has been a clear beneficiary of ongoing growth in China and other countries in Asia. This is due to Australia's abundant supply of natural resources and the ongoing investments within commodities, as well as the secondary impact of being geographically located in a very strongly growing region of the world.

From a local perspective, Australia has been able to effectively manage some of the inherent risks associated with a very strong growth environment. The Reserve Bank of Australia has been proactive in keeping a lid on inflation thus far and has been reasonably optimistic in its expectations for global growth, which have proven to be correct.

The six rate hikes between November 2002 and November 2006 have enabled the RBA to keep rates on hold at 6.25% thus far in 2007. With the market expecting rates to reach closer to 6.75%, PIMCO believes the front end of Australia's yield curve represents value.

**Q: How does PIMCO's secular outlook for continued global growth mesh with the firm's concerns about U.S. growth? And how is this influencing investment strategy?**

**Mead:** Whenever PIMCO's forecasts don't play out as expected, we test and retest every assumption that went into our original forecast. It became apparent that our forecast for a relative slowdown of the U.S. economy was right, but the impact of the U.S. slowdown on the global economy was less severe than anticipated.

But our base case view remains that the impact of the slowing housing market in the U.S. will have an effect on the U.S. consumer, and will not be solely limited to the subprime mortgage sector. We think the market more recently has been underestimating the impact this could have on the U.S. economy and beyond.

The contribution of those secular and cyclical views combined underlies our belief that positioning at the front end of the yield curve is potentially beneficial for all scenarios, particularly given that we have come from a scenario where front ends of yield curves had been flat or inverted in some cases. The difference is that now we have gone from long duration outright to a more neutral position.

The level of the Chinese currency and the impact of environmental issues could potentially derail global growth, and the move towards globalisation. We will need to watch those factors closely, as well as the situation in the Middle East and other geopolitical activity.

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### **Q. Global inflation has been relatively controlled despite the global growth story. What is the outlook for global inflation going forward?**

**Mead:** I think the answer to this question was put succinctly by my colleague Tomoya Masanao...

*"We think inflation will be contained over the cyclical timeframe, which is the next six to 12 months, but expect modestly higher inflation toward the end of our three to five year secular horizon. The change in the driver of the global economy from developed to developing countries, which demand more commodities and other natural resources, is inflationary in and of itself.*

*We also think the integration of workers in China and other emerging markets into the global labour supply, which has been an important disinflationary force, will be less disinflationary going forward. Simply put, labour is going to have more pricing power in China and other Asian economies. While the first half of the migration in China's workforce from rural areas to cities was disinflationary, the second half of that migration will, at the margin, be less disinflationary."*

### **Q. What is PIMCO's view of the Australian dollar and other currencies over the secular timeframe?**

**Mead:** As a result of our global secular view, we remain bearish on the U.S. dollar. This is based on our belief that the composition of global aggregate demand will gradually skew away from the U.S.

The Australian dollar has clearly been benefiting from this shift away from the U.S. dollar, as well as strength in commodity prices and relatively attractive interest rates in Australia. We expect the Australian dollar will maintain this strength over the secular horizon. Our preference for portfolios, however, continues to be towards owning higher-yielding emerging market currencies.

### **Q: Given the secular outlook changes this year, it seems it is not the best environment for bonds. Where does PIMCO see the best opportunities to add value for clients?**

**Mead:** Yes, we are marginally bearish on our outlook for bonds in developed markets globally. However if we continue to expect a robust global economy, we can look to benefit clients by investing in areas not yet reacting to prospects for longer term growth - areas that are under researched like emerging markets and the currencies of those markets.

In addition, we have seen our client base skewing towards more cash-related benchmarks, and we see that as a significantly positive starting point to invest. Considering where cash rates are, and the opportunities that exist to add value, we believe that with careful and cautious selection, there are attractive opportunities in moderately risky assets in Australia.

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Also, we are in an environment where inflationary expectations are reasonable, yields are attractive, and the Australian investor base is starting to look for more yield-driven solutions. We believe PIMCO is very well positioned to offer a range of alternative solutions to meet our clients' needs.

**Q: You mention emerging markets as one area where you will look to add value, but what about corporate versus government debt?**

**Mead:** In the last couple of years, there has been a significant supply of labour as a result of globalization, and corporations no doubt have been the biggest winners, with lower costs of production and the ability to borrow cheaply. As a result, corporations have been extremely profitable, increasing their contribution to GDP along the way.

In deciding what to do with these profits, corporate management have two investor groups to consider: equity holders and bond holders. Following the credit crunch of 2001-2002, corporate management became very bondholder friendly. However, turn the clock forward four years and factor in the firepower of private equity and we have an environment where equity holders have resumed their dominance. Corporations are using their profits to buy back stock and engage in merger and acquisition activity, both of which benefit equity holders.

This trend is not all bad news for bond holders. There will continue to be winners and losers in the corporate sector, and in many ways, we think this is good because it means we can choose our short and long credit investment positions. Having a market that differentiates between winners and losers rather than just a trending market means there is more opportunity to add value.

In emerging markets, sovereigns have been benefiting from some similar global dynamics, but there is not the same equity and bond conflict, so we see it as attractive to invest directly in emerging markets sovereigns.

**Q: Does this mean you will be more dynamic in your corporate investment decision making?**

**Mead:** In recent years, developments in credit derivatives have transformed the credit market from a relatively illiquid, long-only market, to a much more liquid long/short market. Today's credit market provides an array of different opportunities to optimise carry and to tactically adjust positions more quickly and efficiently. As a result, we will seek to be more active in playing the credit market from both a short and long basis.

Another theme for us - not mentioned in the secular view but definitely a by-product of it - is the greater importance and time allocated to structured type products. Even given our moderately bearish view on longer maturity bonds, we believe alternative investments within the fixed interest space, such as long/short, can provide compelling returns to the investor base.

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In this regard, the best in class products around the world from PIMCO's stable will be made available to Australian investors, and tailored to meet investors' specific needs.

### Q: Thank you for your time, Rob.

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