PIMCO's 2006 Secular Outlook

Allianz Global Investors

PIMCO believes that secular economic, social and political trends exert the most powerful and sustained influences on bond markets. PIMCO defines "secular" as the next three to five years. PIMCO's secular outlook guides the way it structures portfolios in terms of duration, yield curve positioning, sector exposure, credit quality and other risk measures. PIMCO develops its secular view at its annual Secular Forum, during which its investment professionals from around the world gather in Newport Beach for three days of discussion and debate about the global economy and financial markets. PIMCO invites outside speakers—experts in economics, finance, history and politics—to supplement its internal analysis. The following are key conclusions from our 2006 Forum:

■ **Global Growth Strong But Vulnerable**—The combination of robust U.S. consumption, massive Chinese investment spending and positive feedback effects in Japan and emerging economies has produced growth that exceeded PIMCO's expectations. This expansion prompted tightening by central banks to contain inflation that was mild but accelerating. The Bank of Japan, the European Central Bank and perhaps still the Federal Reserve are embarked on an uncertain path of interest rate hikes that could, if pursued too aggressively, derail the global expansion.

■ **Global Inflation Benign at 1%–3%**—Moderate inflation is the most reasonable forecast despite the impact of higher commodity prices and the longer-term risk that developed economies will use inflation to ease the burden of unfunded health and pension liabilities. For now, forces of globalization and technology-driven productivity gains, along with the potential for a commodity or housing-related recession sometime in the next few years, will allow global inflation to remain in moderate, range-bound territory.

■ **Interest Rates Closer to Normal Levels But Still Relatively Low**— The reaction of investors and central banks to strong global growth has been to push previously low (and even negative) real, after-inflation yields higher, in part reversing the "conundrum" of artificially low longer maturity yields. PIMCO is reluctant to forecast that rates will move much higher, however. Excess global savings still exist, though some of this saving has been absorbed by higher investment spending from developing economies and global corporations.

Moreover, central banks will continue to tighten cautiously lest they boost the value of their country's currency too much and stall growth. Global real yields should thus stay relatively low over the next three to five years—perhaps 2% on average—and yield curves should have an increasingly positive slope. PIMCO's secular interest rate and inflation forecasts are shown in the table below:

10-Year Note Secular Range Forecast		Secular Inflation Forecast Average
4.0–5.5%	U.S.	2.5%
3.0–4.5%	Europe	1.5%
1.5–3.0%	Japan	1.0%

Source: PIMCO

■ **Riskier Assets at Risk**—Risk premiums and volatility levels in assets such as real estate, corporate and emerging market bonds and equities are near historic lows and financial leverage is near historic highs. Low risk premiums reflect an unrealistic belief that the global economy can keep growing without a hitch. Abundant liquidity, particularly Japan's 0% borrowing rates, has been a significant factor in the compression of risk premiums in almost all financial markets. As this 0% morphs into something higher, investors in riskier asset markets will feel the impact. Leveraged investors will feel even more pain.

■ **U.S. Dollar and Dollar-Based Assets Will Underperform**—The process of reversing imbalances such as the huge U.S. trade deficit and excessive U.S. consumption will demand incentives over the next several years. These incentives are likely to be externally imposed in the form of a weaker dollar, which will allow for reduced Asian imports and a rebalancing of the current disequilibrium.

Investment Implications

■ **Favor High-Quality Assets**—PIMCO manages assets across a broad spectrum of risk categories, but will flavor each of them with a relatively high-quality composition. To not do so would be irresponsible in light of the low reward/high risk character of the global markets, especially those in the U.S.

■ **International Diversification**—A weaker dollar is likely to be accompanied by lower U.S. asset prices in comparison to the rest of the world. While cyclical economic forces may act as a counterweight to this trend, PIMCO portfolios are still likely to feature increasing international diversification in foreign currency terms.

■ **Consider Commodities—**PIMCO believes investors may benefit if they diversify their asset mix with a percentage of commodities. To be sure, commodities qualify as riskier assets and a global slowdown or financial shock would not treat them kindly. Moreover, after their recent strong gains, commodities may not be appealing on a tactical, short-term basis. Still, the global economy will continue to be characterized by resource shortages and potentially even wars over natural resources. "Buying what China wants to buy before China buys it" will, in PIMCO's view, remain a compelling investment adage. Commodities still head China's list.

What the Experts Say

PIMCO taps the best minds in economics, finance, politics and history to help formulate our Secular Outlook. PIMCO invited four outside speakers to this year's Secular Forum. Here is a summary of what they had to say.

Alan Krueger, *Professor of Economics and Public Affairs at Princeton University*
Professor Krueger addressed the topic: "In a globalized, more capitalist world how will sharing of social safety spending between the public and private sectors evolve?" His thesis was that the shift of social spending to the private sector will continue as a result of global competitive pressures and technological change. Employees will bear most of the costs of non-wage benefits in the form of lower wages. It may be difficult for employees to afford and manage their employer-provided benefits as costs rise, making active choices in social security schemes difficult. Social insurance spending in OECD (Organization for Economic Co-operation and Development) countries is roughly 25% of GDP. Health insurance, social security and retirement savings are the largest components of social insurance spending.

Mark Gertler, *Professor of Economics at New York University*
Professor Gertler's topic was "The Bernanke Era: Revolutionary Continuity". He analyzed concepts that will drive Fed Chairman Bernanke's thinking by looking at a "consensus" model of monetary policy. This model depends on expectations of future inflation, interest rates and output. Prof. Gertler said that the Fed should not blindly follow the markets but must be grounded in economic fundamentals. He pointed out two events that have influenced Bernanke—the Great Depression and the hyperinflation of the 1970s. The lesson from these events is to keep inflation stable, which explains Bernanke's fondness for inflation targeting. Gertler concluded that the Bernanke Fed would target a 1–2% band for core inflation but allow temporary deviations from this band. Bernanke's challenge will be to maintain the long run inflation anchor, identify fluctuations in the neutral real rate and deal with uncertain consequences of the U.S. current account and budget deficits.

Charles Gave, *specialist in tactical asset allocation; founder of GaveKal Research and affiliates*
Mr. Gave described "Our Brave New World", in which developed countries are moving towards knowledge-based economies with "platform companies" as the new business model. They place orders for clients and organize delivery by producers, keeping higher value added research, treasury and marketing in-house while farming out more volatile production to emerging markets. Innovations in finance have allowed individuals to manage their balance sheets much like corporations, transferring risk to those able to support it. As volatility has fallen, consumers and corporations have borrowed more, leading to a world awash in capital. Risk premiums have fallen, producing higher asset prices that lower returns, leading to more leverage by investors seeking to maintain returns. Financial discipline in this world comes from financial crises caused by central bank tightening in response to higher leverage and asset prices. The U.S. is not at risk in this system, according to Gave. Investors will keep investing in the U.S. for the safety it provides. China cannot blackmail the U.S. because the U.S. can outsource elsewhere, such as in Vietnam and Africa.

Clyde Prestowitz, *Founder and President of the Economic Strategy Institute*
Mr. Prestowitz focused on the economic rise of Asia. He proposed that 600 years of Western economic leadership are in jeopardy. Asian economies, with huge pools of cheap labor, significant capital reserves, export-based economies and high savings rates, are amassing wealth and power at an alarming rate. Asia's rise does not follow the traditional paradigm of development, whereby poorer countries enter the global economy through low-cost, labor-intensive production and migrate to higher value services. In Asia's case, educated workers, technology-enabled high value services and the sheer number of new capitalists (3 billion) overwhelm the paradigm. The depleted U.S. manufacturing base does not have the export capacity to achieve trade balance. The markets may impose an abrupt correction to this unsustainable disequilibrium. Americans can expect a lower standard of living and a dollar decline of 50% or more.