

2007 Secular Outlook

P I M C O

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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. The secular outlook guides the way the firm 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 the firm’s 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 the key conclusions from the 2007 Forum.

Sustainable Global Growth Over Secular Horizon—Real global growth likely will continue to advance at an annual rate of around 5 percent over the next several years, led by rapid expansion in developing economies such as China and India. More mature economies such as the U.S. likely will be mired at growth levels closer to 2 percent amid demographic challenges and the need for more savings. This relative weakness in developed economies will, however, likely exert downward pressure on real yields, thereby financing rapid growth in emerging economies with an attractive “carry” for investors in that growth.

But With an Early Cyclical Slowdown—The U.S. economy likely will remain weak in 2007 and 2008. The downturn in the U.S. property market has yet to find a bottom, and the corresponding influence on U.S. consumption and global growth has not yet been realized fully.

Global Inflation to Move Slightly Higher—Low cost labor from the developing world and effective monetary policy have contained inflation in recent years, and these forces will still be in play going forward. Still, two important influences will nudge headline, or CPI inflation higher. First is the voracious Chinese/Asian appetite for commodities that will drive those prices higher. Second is a gradual shift in the internal growth dynamics of developing economies, especially China. While China will remain a production-driven economy with high savings, a more internal orientation is developing that will begin to absorb savings, increase consumer demand, and tilt global inflation upward. PIMCO’s secular interest rate and inflation forecasts are shown in the following table.

10-Year Note Secular Range Forecast	Region	Average Secular Inflation Forecast
4.0–6.5	U.S.	3.0%
3.5–5.5	Europe	2.0%
1.5–3.0	Japan	1.0%

Interest Rates Likely to Stay Low in 2007–2008—The weak cyclical environment and potential for Federal Reserve easing point to interest rates closer to the lower end of the ranges shown in the table for the remainder of this year and next.

Then Move Higher a Few Years Hence—Strong growth and higher inflation will push rates higher later in PIMCO’s secular time frame. Global consumption and real rates are likely to be boosted as emerging economies adjust to greater affluence by spending more and saving less at the margin. The bond “subsidy” provided by capital flows from savings-rich developing economies that now hold over 50 percent of U.S. Treasuries will begin to give way to an inevitable diversification toward more risky assets. This shift is already occurring in China.

Capital Will Dominate Labor—The addition of more than a billion workers to the global labor force after the end of the Cold War not only expanded the global economy’s growth potential but will also give capital the upper hand versus labor for years to come. Add productivity enhancing technology investments to the mix and the result is a recipe for accelerating returns to capital and diminishing returns to labor.

Investment implications

Bonds Favorable in Near Term—The weak cyclical U.S. economy argues against a bearish outlook for bonds over the next couple of years, especially in light of expected Federal Reserve easing.

Longer Term, Better to “Own” Growth Than to Lend to It—A secular forecast for robust global growth with a modest uptick in inflation suggests that owners of that growth (investors in equity and equity-like instruments, particularly in emerging markets) will fare better than lenders.

But at a Reasonable Price—Abundant liquidity and a highly leveraged global financial system mean that expected growth is already priced into risk premiums for assets such as corporate bonds and dollar-denominated emerging

market credits. In the fixed income arena, better opportunities will lie in still unexploited local currency emerging bond markets and in the currencies of emerging economies.

Own Non-Dollar Assets and Commodities—Relatively sluggish U.S. growth points to a weaker U.S. dollar and lower relative asset price appreciation than in the rest of the world. Commodities will offer compelling diversification benefits versus paper assets as inflation edges higher.

What the Experts Say

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

Lawrence Summers

Former Secretary of the Treasury and President of Harvard University
Summers's topic was the "Evolution of the Global Economic and Financial Architecture in the Years Ahead." He argued that the biggest influence on the global economy will be continued rapid growth in emerging market countries. This expansion could raise standards of living far higher and for many more people than occurred during the Industrial Revolution. Geopolitical threats in the form of terrorist activity, development of nuclear weapons and regional wars in the Middle East pose the biggest threats to global financial systems. Risk assets have not priced in the probability of adverse geopolitical events.

Martin Barnes

Managing Editor of the Bank Credit Analyst
Barnes's topic was "The Supply-Side Low Inflation Boom: Will It Persist?" He made the case that the supply-side, low inflation long wave of the last 15 years has more room to run. Information technology will continue to play a role similar to that which railroads and autos once played in changing the way businesses are run. The full impact of these

technological advances has not been reached. Productivity gains are at the core of this long wave process. Future economic expansions are likely to be longer and stronger and recessions milder and shorter. In this context, Barnes argued that equities should outperform bonds.

Kenneth Pollack

Director of Research, Saban Center of Middle East Policy
Pollack covered the "State of Geopolitical/Military Play in the Middle East." He reviewed developments in four key areas of the region: Iraq, Lebanon, Palestine and Iran. The dangers in these areas come from civil war or internal discord that have the potential to create failed states and security vacuums that other regional players seek to fill. The result could be heightened terrorism, insurgency and crime. On Iraq, Pollack was skeptical that a long term political settlement could be reached and suggested that U.S. policy should focus on containing the spillover from the civil war. Pollack argued that Iranian development of nuclear weapons was best contained with multilateral diplomacy rather than military force.

Dr. Gang Fan

Director of China's National Economic Research Institute
Dr. Fan spoke about "China's Growth Momentum and Challenges Ahead." He argued that China's growth pattern and demographic pressures are driving their huge current account surplus. About 250 million rural Chinese are expected to migrate to coastal urban areas in the next 5–10 years, necessitating the creation of millions of new jobs. The domestic economy alone will not support this job creation so the need to export will persist, along with trade surpluses. Foreign exchange reserves of some \$1.2 trillion today will continue to grow at a pace of \$300–\$400 billion annually. Dr. Fan argued that China will revalue its currency at a slow pace to keep its exports competitive, despite the risk of trade protectionist measures. The reinvestment of China's reserves in U.S. Treasuries will thus continue, but China will also move out the risk spectrum to diversify its reserve holdings.

Investors should consider the investment objectives, risks, charges and expenses of any mutual fund carefully before investing. This and other information is contained in the fund's prospectus, which may be obtained by contacting your financial advisor. Please read the prospectus carefully before you invest or send money.

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