

PIMCO's Cyclical Outlook



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Paul McCulley Discusses PIMCO's Cyclical 2010 Outlook

PIMCO Managing Director Paul McCulley leads the firm's quarterly Cyclical Economic Forums, in which investment professionals from around the world gather to discuss the outlook for the global economy and financial markets over the next six to 12 months. In the following interview, Mr. McCulley discusses the results of the December Forum and its implications for PIMCO's investment strategy in 2010.

Q: PIMCO recently developed its outlook for 2010. What are the general conclusions?

McCulley: The global economic recovery underway will likely be very much de-synchronized, borne of heterogeneous initial conditions on display prior to the recession, with a full range of possible outcomes. In the developed world, we had double bubbles in property and credit creation. Much of the developing world, in contrast, had already gone through its "baptism by fire" a decade ago and actually had incredibly sound balance sheets in the public and private sector as a starting point.

In addition to these differing initial conditions, there is still uncertainty over three major issues, which in turn creates a range of possible outcomes in our forecast. Depending on how these issues progress, we're looking at multiple potential resolutions of the inherent tension in the overall system. There will likely be some bipolar market outcomes.

Q: Can you talk more about those three major issues?

McCulley: The first issue is the peg between the Chinese yuan and the U.S. dollar, which essentially gives us a one-size-fits-all monetary policy in a very differentiated world. Progress, or lack of progress, on this issue could lead to several outcomes. If China were to let its currency appreciate, it could regain a degree of monetary policy autonomy and

a better ability to manage the risk of overheating and asset price inflation. Another outcome, however, is that China refuses to let the yuan appreciate, essentially maintaining too easy of a monetary policy for itself and the developing countries that shadow Chinese policies. This would create bubble risk, particularly for assets such as emerging market (EM) equities and commodities.

The second major uncertainty is what will happen when the Fed completes its mortgage-backed securities (MBS) buying programs. We know that it will have an unfriendly effect on the interest rate markets, but we don't know the magnitude, because it's too hard to isolate the supply and demand dynamics between fundamentals and the stimulus programs. The key variables are the "stock" effect, or the lingering price impact of the amount of duration taken out of the marketplace, and the "flow" effect, which is the price impact when the Fed stops buying. They'll keep the stock, but they're just not going to be part of the flow any more.

The third uncertainty is any change in the Fed's pre-commitment language, which is currently committed to keeping the fed funds rate exceptionally low for an "extended period." We don't think the Fed is going to tighten any time in 2010, but long before the FOMC (Federal Open Market Committee) actually does the deed, it will have to change its language. That could very well happen in 2010, and there is genuine uncertainty over

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how quickly and strongly the market will anticipate a tightening process. Our gut feeling is that the moment the Fed changes any one of its words, it's going to be a very unpleasant experience, because the marketplace has very little patience and a very big imagination. The most important book at the Fed right now is the thesaurus, and it's probably sitting on top of Paul Samuelson's *Foundations of Economic Analysis*.

Q: Will U.S. fiscal policy play a role in determining the economic and financial outcomes?

McCulley: We don't think the U.S. is going to get a new stimulus package, but there will be a hodgepodge of things that fit the description. In fact, that's one of the reasons that the Treasury has been pushing so hard for the banks to pay back Troubled Asset Relief Program (TARP) money, because the president plans to ask to Congress to move TARP money into Cash for Caulkers and other job stimulus measures. So we will get fiscal stimulus, but it will not be as big or explicit as what we've had so far.

The big unknown gets back to what we've already discussed: We're probably going to have a \$1.4 trillion deficit this year without the Fed on the buy side of the market for duration. There is major uncertainty about how the supply/demand equation for duration will resolve itself when the Fed is out of the picture.

Q: With all these uncertainties, what is PIMCO's global economic outlook for 2010?

McCulley: Cyclical turning points in the context of secular turning points are devilishly difficult to handicap. It was actually easier to make economic forecasts nine to 12 months ago than it is now. Back then, when the global financial system and economy were caught in the throes of the moral equivalent of a life-threatening cardiac arrest, key questions were simple: Would policymakers go "all-in" with their balance sheets, and would those efforts restore private sector risk appetite? The answers have been yes and yes.

But with the yes-yes answers now in, forecasting is much more difficult as markets navigate improved cyclical conditions within the framework of a New Normal secular outlook. Bottom line is that we have a very real possibility of a wide range of economic outcomes in the new year, and it's a dangerous game to maintain a religious devotion to any one in particular. We need to weigh potential outcomes not only from a fundamental economic perspective, but from a behavioral economic perspective that evokes Keynes's beauty contest.

That said, we do have forecast numbers that generally capture the spirit of our discussions: sturdy growth in the emerging markets space, even if less than the Old Normal, and slower growth in the developed countries. Inflation, meanwhile, will probably be too low in the developed world because of still-huge output gaps. What the forecasts can't tell, however, is that asset price inflation—including commodities—is becoming a more important dimension in our forecast because it's becoming a more influential component of central banks' reactions around the world.

Q: How do we reconcile this stronger growth trend we've seen in late 2009 with the lower New Normal growth trend in the forecast?

McCulley: It's true that the fourth-quarter 2009 gross domestic product (GDP) is likely going to be 4%-plus. The inventory cycle is a turbo charger right now. But when we talk about the New Normal growth rate, we're talking in trends as opposed to single quarters.

Forecast	Real GDP		Inflation**	
	Current*	Q409–Q410	Current*	Q409–Q410
United States	-2.5%	1.5–2.5%	1.3%	0.0–1.0%
Europe	-4.1%	0.0–1.0%	-0.1%	0.0–1.0%
United Kingdom	-5.1%	0.5–1.5%	1.5%	1.5–2.5%
Japan	-1.4%	0.0–1.0%	-1.4%	-0.5–1.5%
China	8.9%	9.0–10.0%	-0.9%	3.0–4.0%
BRIM***	1.2%	5.0–6.0%	5.8%	4.0–5.0%

* For U.S., GDP and inflation as of 09/30/09. For Europe and U.K., GDP as of 9/30/09 and inflation as of 10/09. For China, GDP as of 9/30/09 and inflation as of 11/09. For Japan, GDP as of 9/30/09 and inflation as of 12/09. For BRIM, GDP is Q4/09 estimate and inflation is 12/09 estimate.

** U.S. inflation is Core PCE. (Note: Core PCE is usually about 50 bps lower than Core CPI.) Japan inflation is Core CPI.

*** BRIM represents Brazil, Russia, India and Mexico.

The real story here will be told not in the GDP numbers, which are being driven by the inventory cycle, but by real final sales, which will continue to face the headwind of balance sheet deleveraging in the household sector. This is a critical tenet of the New Normal. Consumers can't and/or won't augment personal income by borrowing, so consumption must grow in line with personal income. Consumption isn't likely to get a boost from the increase in stock market wealth because home values—a larger part of individual wealth—are still depressed. Thus, savings rates may stabilize at 4% or 5%, but may go as high as 8%. Additionally, unemployment hurts personal income, as those without jobs have no income and the huge unemployment gap means that even if you have a job, you do not have the leverage to ask for a big raise.

Q: What are the investment implications of the cyclical outlook?

McCulley: As we translate all of this into investment strategy, we have to be incredibly cognizant of lingering uncertainties and the full range of potential outcomes. Because that range is so wide right now, our risk-taking is more tame than it would be if we had a normal distribution of expected outcomes. For now, we are limiting overall risk exposures, but we have to be ready and willing to recognize alternatives to the baseline forecast if and when they unfold, and to act opportunistically.

This all leaves us with portfolios that appear, more than at other times, to be hugging the benchmarks with no bold positioning. Some might suggest we've become closet indexers, but, on the contrary, we're making a very active decision to run light on risk. At this point, we know this is not going to be a particularly high-yielding portfolio. You can only eat what's in the cafeteria, and right now the cafeteria doesn't have anything particularly appetizing in it.

Q: How is the outlook being reflected in portfolio positioning?

McCulley: For interest rate exposure, or duration, we are currently cutting back in the U.S. and U.K. because, as mentioned before, supply and demand dynamics are likely to be negatively affected as borrowing rises and central bank buying declines. On the other hand, we remain modestly bullish on duration in the Eurozone, which has been

congenitally disinclined to be aggressively Keynesian and won't face the same degree of reduction in central bank duration buying in 2010. Regarding curve duration, we continue to remain modestly overweight.

With corporate bonds, we are becoming a bit more cautious than we have been. In the third and fourth quarters of 2009, we believed the massive narrowing of spreads we saw in the second quarter wouldn't go much further. We weren't necessarily selling credit on any scale, but we'd reduced buying. Now, we're generally neutral versus the benchmark, but we believe that corporate spreads are still at levels where we see value in carefully selected high-quality credits, particularly in bank and non-bank financials and non-cyclical sectors, such as utilities and healthcare. In high yield corporate, we are adding very select names in telecoms and energy pipelines that we view as "money good."

In agency MBS, we are underweight, having reduced our exposure as the Fed's buying programs have dramatically tightened spreads.

Our overall currency target is to be about 3% long a basket of emerging market currencies, generally against the benchmark portfolio currency. Similarly, we're favoring emerging market sovereign credits, and the Dubai panic gave us additional legroom to enter into these trades. We are also adding to positions in EM corporate bonds.

Though we view Treasury Inflation-Protected Securities (TIPS) as a strategic long-term allocation, on a tactical basis we are underweight TIPS versus the benchmark, reflecting our view that risks are currently weighted toward a disinflationary environment.

We do like Build America Bonds, but are fairly neutral on plain old municipal bonds. The technical supply/demand picture for munis is actually quite favorable, especially since Build America Bonds have accounted for supply that would have otherwise been muni supply. The only thing that keeps us from being all-in on munis is the fact that the New Normal environment will not likely be especially kind to states and localities, requiring extremely careful credit selection.

Thank you, Paul.

About the Author

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Mr. McCulley is a managing director, generalist portfolio manager, and member of the investment committee in the Newport Beach office. In addition, he heads PIMCO's short-term bond desk, leads PIMCO's cyclical economic forums and is author of the monthly research publication, Global Central Bank Focus. Prior to joining PIMCO in 1999, he was chief economist for the Americas at UBS Warburg. From 1996 to 1998, he was named to six seats on the Institutional Investor All-America fixed income research team. He has 26 years of investment experience and holds an MBA from Columbia Business School. He received his undergraduate degree from Grinnell College.

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