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Secular Outlook

PIMCO

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A Tale of Two Cities

At the end of PIMCO's 2008 Secular Forum, Bill Gross suggested to me that *A Tale of Two Cities,* the title of Charles Dickens' classic, would be a great way to capture three days of stimulating discussion among PIMCO colleagues stationed all over the world, four superb outside speakers, and Alan Greenspan. While he is right, I am ashamed to admit that I am unable to pursue properly his suggestion.

As I noted at the end of the Forum, I have never read this important book. And to make things worse, my partial impression of it is heavily influenced by an event that I doubt captures the essence and richness of Dickens' much-admired work.

Some of you might recall that *A Tale of Two Cities* was the topic of a funny exchange in a 1980s episode of "Cheers," my absolute favorite series on television. If my memory serves me right, a woman working at the bar tries to raise the intellectual level of the discussion by arranging for a group reading of the book. She doesn't get very far. The focus of the group breaks down quickly after she reads out the famous beginning: "It was the best of times, it was the worst of times." The phrase immediately triggers funny reactions from others in the bar, with lots of commentary as to how confused Dickens must have been! The attempt to restore order by reading what follows—"it was the age of wisdom, it was the age of foolishness; it was the epoch of belief, it was the epoch of incredulity"—only serves to provoke a further (hilarious) deterioration of the already fragile order in the bar.

So, what am I to do as I contemplate how to carry out the heavy responsibility of summarizing a vigorous and stimulating discussion informed by the insights of our outside speakers (see box), as well as the ideas of our new MBA class? And don't underestimate the seriousness of the task. During my two years back east, I met hundreds of investment managers pitching their services to Harvard. The process confirmed to me that very few firms have made the effort to

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hardwire a disciplined secular process that identifies new opportunities *and* reduces the risk of being sucked into crowded trades at the wrong time.

At the risk of sounding too uncultured, allow me to draw on a recent Disney hit to capture the essence of our discussion at the Forum (and, in the process, impress my five-year-old daughter who loves the movie). In "Enchanted," a beautiful princess (Giselle) is on her way to a dream wedding in a fairy tale land when she is thrown into a deep well by a jealous witch. She emerges in modern-day Manhattan where every encounter is initially hostile and unpleasant. With time, Giselle finds her bearings and ends up living happily ever after, albeit with an important twist and a different destination.

The global economy is going through a similar journey. The "Great Moderation," and the fairy tale of "Goldilocks," have given way to the reality of having to adjust to the consequences of over-leverage, excessive financial alchemy, lax due diligence, and spotty supervision and regulation—all of which have been well documented in Bill's IOs of recent years. As in the case of Giselle's initial experience in Manhattan, the result is far from pleasant and includes large losses on Wall Street, market accidents, and a policy and regulatory catch up process that is inevitably iterative and imperfect.

The big question for our Forum was the extent to which these disruptive cyclical factors would contaminate the longer-term outlook. Will the global economy be able to overcome the nastiness and end up like Giselle restoring stability, albeit with a twist and in a different set up? Our answer

PIMCO's 2008 Secular Forum Speakers

John Plender, a senior editorial writer and columnist at the *Financial Times* whose insightful columns, as well his 2003 book *(Going Off the Rails - Global Capital and the Crisis of Legitimacy),* have identified many trends that have subsequently proved consequential for global markets

Raghu Rajan, the brilliant professor at the University of Chicago, whose approach admirably combines academic rigor with an understanding of how finance behaves in the real world and acts as a catalyst for analyzing regulatory initiatives and the incentive structures in the financial markets

Mike Spence, the impressive 2001 Nobel Prize Winner, has spent the last two years intensely studying growth dynamics in emerging economies, including as chair of the "Commission on Growth and Development"

Nassim Taleb, whose best selling book *(Black Swan)* is just one illustration of his superb ability to highlight the inherent vulnerability of certain aspects of behavior that markets take for granted…until they go horribly wrong

was to re-affirm the secular outlook that came out of last year's Secular Forum, while adding some qualifiers that affect the journey and the contours of the ultimate destination.

PIMCO's Secular Baseline

We started with a rather stark characterization of what economists like to call "the initial conditions." After years of over-relying on the U.S. consumer, financial leverage and untested alchemy, the global system finds itself in a dead end. Imbalances have gotten too large to allow for another bout of debt-financed economic activity, and we have reached a limit in the ability of the system to create another layer of endogenous liquidity and to support yet again poorly-capitalized activities. Instead, the emphasis is on de-leveraging, a process that inevitably involves disruptive overshoots and considerable collateral damage.

In order to regain its composure in a durable fashion, the global system will have to (i) undo some of the recent journey and (ii) pave a new path. To do so requires more than just appropriate actions on the part of both deficit and surplus countries; it also speaks to the capacity of the global system as a whole to accommodate the changes.

In kicking the tires of last year's Forum, we re-affirmed that the global economy will likely maintain a solid pace of economic growth over the next 3-5 years. Indeed, while the U.S. is facing larger headwinds and a cyclical downturn, emerging economies are reinforcing a truly historic breakout phase that will see them continuing to assert themselves as the main engine of growth for the global economy.

We also confirmed our view that inflationary pressures will continue to increase over the secular horizon. The re-pricing of the commodity complex, which is driven to a large extent (but not exclusively) by higher demand, will be accompanied by higher wages in emerging economies and larger social spending in both emerging and industrial economies. More generally, and especially from the perspective of the U.S., look for inflation to become more sensitive to foreign factors.

These two factors would, in themselves, contribute to a likely reversal in the secular bullish run for corporate profits in industrial countries. Moreover, the financial sector will have to spend more time strengthening its balance sheet through a mix of capital raising and deleveraging. Indeed, we expect a fundamental realignment of the U.S. financial system

as the recent set of crisis management reactions morph into a more consistent longer-term response.

The Federal Reserve's financing window for primary brokers, introduced on March 16th in the midst of the Bear Stearns crisis, will likely evolve into a permanent facility that is accompanied by stepped up regulation and capital requirements. As investment banks are forced to converge over the next few years towards the lower leverage model of commercial banks, they will seek ways to secure a deposit base that can reduce their cost of funding, including through merger and acquisition. This process of de-leveraging and, if done properly, de-risking will have a number of implications for investors. And by creating an initial vacuum in the more highly leveraged space vacated by investment banks, it will entice new entrants, some of which will come from the current generation of private equity and hedge funds.

Risk Factors

We reached these conclusions only after extensive discussion and debate. Or, put another way, we acknowledged that there are risks to our baseline that warrant close monitoring—especially those that involve the possibility (though not the overwhelming probability) of discontinuities. These risks fell generally into three distinct, but interrelated buckets.

The *first* set speaks to how segments of the global economy will deal with "debt exhaustion" in industrial countries. The major concern here is the U.S. consumer who is yet to recapitalize his/her balance sheet notwithstanding mounting pressure from sluggish employment, high energy and food prices, less ample access to credit and, most importantly, a housing price correction that is still far from complete.

This risk has important policy implications. Simply put, policy makers do not have good policy tools to deal with the destabilizing combination of asset price *de*flation, and goods *in*flation. The U.S. federal reserve is particularly challenged on account of its "dual mandate" that calls for maintaining solid employment *and* low inflation. This comes at a time when regulators are trying to play catch up with a financial system that has morphed into something that does not fit neatly into existing frameworks and mindsets. The genie is out of the bottle and there is no easy way to put it back! Moreover, the longer the delay out of Washington DC in implementing fiscal measures to stabilize the housing sector, the greater the risk

that the higher collateral damage on Main Street will induce a politically-driven regulatory over-reaction with unpredictable economic outcomes.

The second set of risks centers on the hypothesis that the global economy may hit a binding speed limit. Specifically, we discussed the implications of both macro dampening factors, such as global warming, and more specific ones, such as China's ability to maintain a responsive and effective policy stance. We also analyzed the extent to which higher inflation in the emerging world could sap its growth momentum.

Finally, we were conscious of the fact that we no longer live in a "diversified enough ecology" due to massive advances in networking and inter-connectivity, especially in the financial sector. The resulting lack of redundancy in the system, though efficiency enhancing, increases the globe's vulnerability to shocks that are quick to spread yet are unpredictable in origin and total impact. The risk is a series of feedback loops that balkanize markets and force policy makers to choose bad policy measures among an already inferior set of policy alternatives. Recent developments in the energy and food markets confirm that this phenomenon is not specific to just the financial system.

Some Intrinsic Secular Stabilizers

By now, you must be wondering why these risk factors, many of which are already visible and consequential, do not result in a more dire secular outlook. The answer lies in the robustness of the ongoing handoffs that are reinforcing the journey to a new *multi-polar* growth world. Let me cite just two of the many elements that we discussed in this regard.

First, the major required shifts are now in the domestic interest of key players in the global system. Emerging economies are recognizing the longer-term benefits of a more balanced growth path that is not so reliant on external demand. This includes China where the domestic socio-economic imperatives call for a gradual policy shift that stimulates consumption and accelerates the adoption of market-based systems, including a more flexible exchange rate.

Second, it would be unwise to ignore the capacity of the global system to secularly recapitalize its most vulnerable segments, albeit sometimes in a rather disorderly cyclical fashion. If you think about it, the world has been going through a sequential secular recapitalization process: emerging economies (1997-2002, prompted by the Asian, Russian and Latin American crises), industrial country

corporates (2002-03, with the Enron and WorldCom disasters acting as catalysts), and banks (today). The U.S. household will inevitably be the next part of this process in the period ahead.

Investment Implications

Anchored by this multi-year framework, PIMCO is well armed to define rail guards within which we will position our clients' portfolios as we seek to continue to deliver our traditional out-performance in the context of a cautious risk management mindset. Indeed, and as we expressed earlier this year in one of our rare decisions to place advertisements in the financial press, our mantra remains "Manage risk. Deliver returns"—and this pertains not just to bonds but also a growing array of investment choices and solutions for our clients.

So, how does our secular outlook specifically impact cyclical portfolio positioning in the period ahead? Let me give you a feel by citing four examples.

Look for us to place emphasis on "spread duration" as an appropriate driver of performance; but don't expect us to do so indiscriminately: The mix of current conditions and secular forces call for this to be done initially through a heavy emphasis on the senior part of the economy's capital structure, including institutions and instruments that are now subject to systemic de-risking.

Expect us to search for value in the re-alignment of the financial system that is heavily influenced by regulatory-induced de-risking: The regulatory reaction serves to clip part of the tail risk of institutional failure but at the cost of an unambiguous decline in the expected return on capital—a phenomenon that will tilt relative value in the direction of bond holders and away from equities.

Do not be surprised by our limited enthusiasm for taking "interest rate duration" risk in the U.S., especially beyond the front end of curves: Yes, secular bear steepening have been rare but the U.S. faces an unusual set of circumstances. Look for Fed policy to be driven by a focus on worrisome employment dynamics and, as such, be less aggressive than history would suggest in the manner it reverses recent interest rate cuts. Meanwhile, the Fed will have no choice but to retain only limited control over the longer end of the yield curve which will be impacted by the financing of higher fiscal deficits and the cost of attracting foreign investors that are already heavily exposed to the U.S.

Look for us to position again for renewed dollar weakness, but with

an important difference: The currencies carrying the brunt of the offsetting appreciation over the next few years will be dominated much less by floating regimes (such as the Euro) and much more by those subject to less flexible foreign exchange systems (especially in Asia).

These are just some of the ways in which our secular themes will influence portfolio positioning. And there is an important, Enchanted-like, duality: the secular forces identified last year remain in play yet there have been dramatic short-term dislocations that will inevitably impact the exact set up of the secular destination.

Now, who was it that wrote "It was the season of Light, it was the season of Darkness; it was the spring of hope, it was the winter of despair?" Charles Dickens? If only I had spent part of my youth reading *A Tale of Two Cities*! Well, you know what they say, it's never too late to read a classic.

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Some of PIMCO's Secular Themes

- Continued robust global growth that, in composition, is less G-3 centric and driven to a greater extent by emerging markets that are in the midst of a development breakout phase
- An upward trend in global inflationary pressures reflecting the spillover of global demand into commodities, gradually rising wage rates in emerging economies, industrial/developing policy responses that place greater emphasis on employment and social spending, and a U.S. monetary policy that may be domestically appropriate but internationally inflationary
- A reversal in the secular bullish run for corporate profits in industrial countries, overall and relative to labor
- Institutional re-alignments in the global financial sector: In industrial countries, this will be driven by regulatory changes and post-crisis balance sheet management; and in emerging economies, it will be driven by the further maturation of capital markets and the evolution of sovereign wealth funds

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