PIMCO

Economic Outlook

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Saumil Parikh Discusses PIMCO's Cyclical Outlook

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Mr. Parikh is a managing director and generalist portfolio manager in the Newport Beach office. He is head of macroeconomic research for North America and also serves as a member of the short-term, mortgage and global specialist portfolio management teams. Prior to joining PIMCO in 2000, Mr. Parikh was a financial economist and market strategist at UBS Warburg. He has 12 years of investment experience and holds undergraduate degrees in economics and biology from Grinnell College.

Each quarter, PIMCO investment professionals from around the world gather in Newport Beach to discuss the outlook for the global economy and financial markets. Saumil Parikh, managing director and portfolio manager, recently assumed leadership of these forums. In the following interview, he discusses PIMCO's cyclical economic outlook for the next six to 12 months.

Parikh is a generalist portfolio manager and member of our global, short-term and mortgage teams. In addition to describing our economic outlook, he comments on investment strategies that PIMCO is applying to manage risk and deliver returns in a world of multi-speed growth.

Q: PIMCO recently raised its cyclical outlook for the U.S. economy. Why the more sanguine near-term view?

Parikh: During our Cyclical Forum earlier this month, we agreed that the U.S. is experiencing a revival of consumer "animal spirits" due partly to the Federal Reserve's decision to expand quantitative easing, but more importantly due to the White House's move to the "center" with a renewed expansionary fiscal policy thrust for 2011. Most notably, the inclusion in the White House tax compromise of a one-year payroll tax holiday that trims everyone's social security taxes by 2%. That's a very front-loaded tax cut – it will add to household cash flow starting immediately on January 1, 2011. Overall, the combination of tax cuts, unemployment insurance extensions and business investment deductions will likely add 1 percentage point to real GDP growth (not including inflation) over the next year. Thus, we now expect real GDP to expand at a rate of 3% to 3.5%, up from our prior forecast of 2% to 2.5%.

It is important to stress that we see a one-year cyclical bounce in U.S. economic growth as a result of these monetary and fiscal policy measures, but also, that structural issues remain unaddressed, including the persistence and nature of elevated unemployment and extremely high public and private debt levels. This forecast upgrade is a case of kicking the can down the road. We are once again borrowing from the future to enhance growth today. The still unanswered question for 2011 and beyond is how long global investors will continue to tolerate the excessive use of the U.S. public balance sheet for short-term growth benefits before downgrading their risk assessment of either the U.S. dollar or U.S. Treasuries.

In any case, the U.S. economy over the next three to five years will likely struggle to hit 3% real GDP growth, and that is very much in line with our New Normal worldview. We see evidence that the key tenets of the New Normal will continue and that absent a major policy reorientation, industrial countries over a long horizon will face stubbornly high unemployment; private and public sector debt deleveraging; and (for those with the most highly burdened fiscal balance sheets) periodic concerns about sovereign risk.

Regional Cyclical Forecast

	Real GDP		Inflation**	
	Current*	Q1 '11 – Q4 '11	Current*	Q1 '11 – Q4 '11
United States	2.6%	3.0% – 3.5%	1.3%	0.75% – 1.0%
Europe	1.4%	0.5% – 0.75%	1.5%	0.5% – 0.75%
United Kingdom	1.9%	1.0% – 1.25%	2.7%	1.75% – 2.0%
Japan	1.5%	0.75% – 1.0%	−0.4%	−0.5% – −0.75 %
China	9.3%	8.5% – 8.75%	3.7%	5.0% – 5.25%
BRIM* **	5.4%	6.75% – 7.0%	5.8%	5.75% – 6.0%

* Current data for real GDP growth and inflation represent year-over-year consensus estimates for Q4 2010 – Q4 2011.

** U.S. inflation is Core PCE. (Core PCE is usually about 50 basis points lower than Core CPI.) Japan inflation is Core CPI excluding fresh food.

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

Source: PIMCO

Q: Let's talk more globally, beginning with PIMCO's outlook for Europe.

Parikh: Unfortunately, the eurozone continues to be the darkest spot in the global economy as we look forward for the next six to 12 months. Things have recently gone from bad to worse in terms of sovereign risk in Europe.

Over the last three weeks, there has been accelerated discussion of doing something more comprehensive than the piecemeal approaches tried thus far, culminating in an agreement among European Union leaders to replace their emergency rescue fund, which expires in 2013, with a permanent crisis-resolution program. Yet more is needed between today and 2013. Truly fixing the sovereign debt crisis in Europe would require overcoming a great political divide between "core" and "periphery." Germany is perhaps the only country in the eurozone with the financial ability to guarantee government bonds of troubled peripheral nations, but that is a politically unpopular option within Germany. On the flip side, the weakest peripheral nations need to make very difficult choices that essentially force them to surrender their future fiscal policy authority to Germany and other "core" countries in Europe in exchange for liquidity assistance today.

Policy coordination failure, coupled with political failure, is a non-trivial risk in Europe over our cyclical horizon. It is conceivable that one or more sovereign defaults in Europe give rise to a banking crisis with potentially deleterious consequences for "animal spirits" around the world.

Q: Emerging markets (EM) have been a hot topic these days among investors. On the other hand, policymakers in countries such as China are trying to cool off domestic asset prices. Have these efforts changed PIMCO's views on the attractiveness of EM?

Parikh: Key emerging markets are experiencing more robust growth than developed economies, and they generally have more favorable public and private sector balance sheets with the potential to foster domestic consumption growth. So, we remain very bullish on EM.

With that said, this block of rapidly developing economies is increasingly faced with a policy "trilemma" that forces each country to choose between free capital flows, managed exchange rates, and independent monetary policy; it's possible to achieve only two at any given time. China is at one extreme of the spectrum within the emerging markets. Because China has adopted a closed capital account and a hard currency peg, it is able to withstand the easy monetary policy of the United States and Europe with better effectiveness than its emerging market peers via regulatory and macroprudential controls domestically. Other countries, such as Brazil, Korea, Singapore, India, Indonesia etc. fall short of China in terms of policy independence, where semi-porous capital accounts and soft pegs do not allow them to effectively tighten monetary policy and remain competitive vs. both China and the United States at the same time. In a world where "beggar thy neighbor" is turning into "bubble thy neighbor," the policy trilemma in emerging markets is becoming a critical factor in growth dynamics.

Q: So what does your outlook, especially the more robust forecast for near-term U.S. growth, mean for interest rates?

Parikh: Changes in U.S. interest rates and bond prices over the last four or five weeks, in our opinion, fully reflect the upgrade in U.S. growth prospects for 2011. Using a Taylor Rule projection for the fed funds rate to 2015, we find that the U.S. bond market is fully discounting 3.5% real GDP growth in 2011, followed by 4% real GDP growth in 2012 thru 2015 – a growth projection beyond 2011 that outpaces our own expectation. (The Taylor Rule is an interest rate forecasting model invented by economist John Taylor.)

Looking to 2012 to 2015, the New Normal remains firmly entrenched in our view as long as private sector deleveraging continues and the public sector has increasingly diminished bandwidth for yet another major stimulus package. Thus, we believe the fixed income market has already priced in the one-year uptick in growth as well as a gradual rise in the federal funds rate beginning in early 2012. The upshot: The secular outlook for fixed income is much more stable from this starting point of higher yields, in particular for those investors who concentrate their fixed income risk in the front-end of yield curves where a significant amount of Fed tightening is already priced in.

Q: Let's drill down further into strategy. What investment themes are you highlighting these days, including with the Total Return strategy?

Parikh: The one theme that we continue to enact is a focus on "real returns" and "safe spreads." The upgrade in our U.S. GDP outlook from below-potential growth to above-potential growth over the cyclical horizon should mean that volatility in markets moves away from credit volatility and toward interest rate volatility. A stronger economy due to fiscal policy expansion should benefit most corporate and household balance sheets via enhanced cash flows, and, therefore, we see credit risk as less of a factor over the

cyclical horizon and we are reorienting the Total Return strategy toward more credit spreads, and away from interest rate spreads, as we seek yield and alpha for our clients.

Q: Finally, are there specific sectors within credit that PIMCO views as favorable?

Parikh: Within the high yield market we see attractive opportunities with bank loans, which are essentially secured senior obligations of high yield companies. We feel bank loans are likely to do very well in an environment where macro-liquidity is high and where cash is flowing freely around the economy thanks to the federal government. We also believe the market for bonds issued under the Build America Bonds program – which appears very likely to expire at the end of the year – offers very attractive spreads per unit of risk, per unit of leverage and per credit rating in comparison to the broader credit market. Within the universe of fixed income instruments that are AA-rated and higher, it's hard to find opportunities that are yielding Treasuries plus 200 to 300 basis points, so we think Build America Bonds are an incredible opportunity right now. And the third area of focus is emerging markets, with the best performing nations continuing to have fast economic growth, high cash flows and clean fiscal balance sheets. A tilt toward emerging market credit is warranted considering our global outlook, especially in relation to avoiding credit risk in the eurozone.

Thank you, Saumil.

"Real Returns" refer to returns adjusted for changes in prices due to inflation or other external effects.

"Safe Spread" is defined as sectors that we believe are most likely to withstand the vicissitudes of a wide range of possible economic scenarios. All investments contain risk and may lose value.

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