PIMCO

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Secular Outlook Series

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Scott Mather

Game Change for Bond Investors?

Bond investors may be anxiously watching reports on inflation or economic growth, trying to decide if they are making the right allocations amid confusing signals.

In the second of a series of Q&A articles accompanying the recent release of PIMCO's Secular Outlook, portfolio manager Scott Mather discusses how macro factors may affect bond markets over the next few years.

Q. There seems to be a great deal of uncertainty about the outlook for bonds. What would you suggest investors consider first?

Mather: To start with, I suggest putting aside any typical cyclical model that may have been useful in the past. Over the secular horizon, say the next three to five years, we argue that market behavior may be vastly different than what models would predict. One reason: sovereign debt, which is at the core of our global financial system, is undergoing a seismic shift. We expect that over the next several years, one way or another, this core will degrade in creditworthiness. So investors have to wonder, what does it mean when the core weakens?

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Investors may find it more difficult than they expect to avoid sovereign debt risk. Media reports seem to suggest the sovereign debt problem is concentrated in peripheral Europe and if that can be addressed then the problem is solved. In reality, peripheral Europe is distracting people from problems in the much larger developed world. And, I argue, one cannot escape sovereign debt issues simply by moving into other asset classes, because equities, real estate and all other investments will be affected if sovereign debt of a nation deteriorates.

Thus, policy decisions over public deficits could be paramount to investors, as well as central bank moves to buy or sell government debt or direct interest rates.

Q. Is inflation risk also a critical concern for investors?

Mather: We appear to be on the tail end of a period in which higher energy prices push up headline. It is possible we will see further volatility in energy prices leading to more such periods. However, our outlook is for gradually rising inflation over a secular horizon, with inflation in emerging markets (EM) a few percentage points higher than in the developed world. But we have to recognize that inflationary accidents are a rising risk, especially in EM, and also over the longer term in developed markets depending on the policy mix chosen.

The key is what happens to inflationary expectations. With four decades of experience, we have observed that bond markets do not move on higher headline inflation unless investors believe the higher inflation will be sustained. And that is why we look at core, which excludes volatile food and energy prices. Core reflects everything else going on in the economy, and core generally budges only amid a wage spiral, which would generally occur if people anticipate higher inflation and demand higher wages to offset it. We find that scenario unlikely to unfold in the developed world over the next several years given the substantial economic slack and unemployment.

There are risks to our view, of course. For example, if the output gap narrows and we see broad money and credit growth. But so far we have not seen any credit growth whatsoever. Base money growth is sitting in excess reserves held by central banks all over the developed world. It is sitting in the Federal Reserve, the European Central Bank, the Bank of England and the Bank of Japan. The banking system could, if it was actually lending, turn that into broad money growth.

One more thing: Central banks have built up their credibility, and that adds to difficulty in shaking inflation expectations in the developed world. This is unlikely to change in the near term, in our view, but over a longer horizon it certainly could if deficits persist.

Q. Could you discuss the concept of financial repression and why investors should be concerned? Is it working?

Mather: Financial repression is any public policy that is designed to influence the market price of financing government debts, either through government bonds or the nation's currency. Direct methods of repression include things like setting target interest rates, monetizing government debt or implementing interest rate caps. Indirect methods include polices designed to change the amount of debt or currency at a given price. Examples include requirements to hold minimum amounts of government debt on bank balance sheets or establishing minimum requirements for government bonds in pension funds.

Governments may take these steps to improve their ability to finance public debt and forestall more painful adjustment processes, though there can be other motives, and because these methods are less transparent, and thus less controversial, than direct tax hikes or spending cuts. Investors should be wary of financial repression because it is primarily a tool to redistribute wealth from creditors (citizens) to debtors (governments) to the detriment of creditors, fixed income investors and savers.

We are seeing a circular dynamic with developed and emerging economies both expanding use of financial repression. With an eye to boosting economic growth while keeping debt funding costs low, developed country central banks are keeping interest rates low and have done more

extreme measures, including direct purchases of government debt. These activities, when coupled with developed world trade deficits, have contributed to pressure on EM currencies to appreciate.

EM countries then resist this appreciation by directly intervening in currency markets and accumulating advanced economy currency reserves, namely the U.S. dollar, which are then reinvested in mostly developed world government bonds, helping to push down developed nation interest rates further! This is a global circle of financial repression in which policymakers are influencing prices of bonds and currencies as well as interest rate levels.

It is important to realize these methods as practiced are only partially effective and cannot go on forever, as advanced economies continue to add significantly to their public debts despite low financing costs. Some intensification of financial repression, fiscal austerity or stronger growth must occur to lower the likelihood of a future debt crisis.

Q. We began by discussing how fixed income markets may be changing. What are the opportunities for investors amid such change as well as the risks?

Mather: Certainly we feel there is going to be much less policy coordination and much less real economy correlation in years ahead. Much of the past several decades can be characterized by growing sameness; convergence themes worked well as countries adopted similar polices and economies became more correlated. In contrast, we think the next several years will be better characterized by the differences that will emerge from vastly different initial conditions and varying policy responses. To the extent the differences among global markets will become more pronounced this begets opportunities for investors.

We have been encouraging investors to seek out safer balance sheets. With respect to sovereign investing, emerging markets standout with respect to more developed sovereigns in that they have improving credit profiles. We have been encouraging investors to focus on "safe spread," with an emphasis on improving balance sheets within the corporate universe as well. Businesses have taken advantage of lower rates to lower their financing costs, while the economic recovery has boosted their sales.

Finally, in terms of financial repression, as developed nations suppress short-term interest rates, we generally see a steepening of the yield curve and that can create opportunities in carry and roll down to add to bond returns.

We also see opportunity in emerging market currencies, which we expect will appreciate vs. currencies of developed nations. EM policymakers who have resisted appreciation, we suspect, will eventually allow more appreciation over the next three to five years as they nurture domestic consumption and their economies become less dependent on export demand. In contrast, developed country currencies are likely to depreciate from the confluence of declining credit profiles, financially repressive policies and relatively poor growth.

Thank you, Scott

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