

PIMCO Secular Outlook

|||| PIMCO's Secular Outlook 2009

06/01/2009

PIMCO's secular (three- to five-year) outlook guides the way it 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 its investment professionals from around the world gather for three days of discussion and debate about the global economy and financial markets. Also invited are outside speakers - experts in economics, finance, history and politics - to supplement the firm's internal analysis.

The following are key conclusions from PIMCO's 2009 Forum:

KEY CONCLUSIONS

PIMCO believes that following the severe shocks to the global economy in the second half of 2008, the world embarked upon a journey of change not likely to be reversed over the next few years. This journey, likely characterized by starts, stops and volatility, will include some of these features:

- **Slow Growth in Developed Economies** – Growth rates in developed economies are likely to be lower over the next three to five years. Potential growth in the U.S. could fall from 3 percent in the recent past to around 2 percent. One reason is debt exhaustion at the household level (especially in the U.S. and U.K.) and deleveraging among financial institutions that will make it difficult for the global economy to adjust as it has in prior economic crises.
- **Politics Matter** – Another reason for muted growth will be a dampening of productivity as the public sector overstays as a provider of goods that belong in the private sector. More regulation and higher taxes will restrain the growth of output. While government involvement was clearly necessary to stabilize the financial system, the global economy is now highly vulnerable to policy mistakes. These could include protectionism, mismanagement of public finances and the overriding of investors' contract rights.
- **Emerging Economies to Bifurcate** – In general, emerging economies should grow faster than the developed world. There will be a continuing shift in the balance of economic power away from the major developed economies and toward important emerging countries. Emerging economies will divide into two groups. Countries with fiscal and economic imbalances will return to the old paradigm that alternates between austerity and instability. Those in stronger financial condition and with growing internal markets, such as China, will maintain their development breakout phase, thought not at the torrid pace of recent years.
- **Short Term Deflation, Long Term Inflation** – Deflation risks should predominate in the near term given the severity of the collapse in global demand and the resulting large gap in actual versus potential output. Inflation risks will come to the fore later in PIMCO's secular horizon, however, as potential output becomes more constrained, in part due to supply destruction, and policymakers struggle to withdraw the massive levels of monetary and fiscal stimulus that have recently been introduced.
- **U.S. Dollar Risk** – In the U.S., inflation risk and currency risk are linked. Should U.S. policymakers lack the commitment or the skill to drain the system of emergency liquidity at the appropriate time, confidence in the U.S. dollar as the world's reserve currency could erode.
- **Banking and Finance to Shrink** – The financial sector's formerly commanding presence in the economy will be curtailed. With regulation more expansive, the sector will be de-risked, de-levered and subject to greater burden sharing by politicians. Consolidation will spread beyond banks to non-bank financial institutions and the investment management industry.

IMPLICATIONS FOR PIMCO'S PORTFOLIOS

- **Favor the Front End of Yield Curves** – Yields on short maturities are likely to be anchored near current low levels for a longer period than what is now priced into forward interest rate curves. Policymakers in many countries are likely to overstay with loose monetary policy.
- **Emphasize Income-Producing Instruments** – An environment of low growth and political uncertainty favors high quality, yield-oriented securities over those offering mainly capital gains. With regard to credit risk, it will make sense to stay relatively high up in capital structures, as yield premiums and valuations of equities and subordinated securities will reflect heightened risks of burden sharing and contract disruptions.
- **Focus on Global Securities** – Diversification outside the U.S. will likely yield benefits. U.S. bonds, especially Treasuries, will face greater sovereign risk as the U.S. debt burden mounts and inflation expectations start to rise later in our secular time frame.
- **Hedge Against a Weaker U.S. Dollar** – Investors should look to protect themselves against the risk that U.S. policymakers will not be able to prevent erosion in the value of the dollar. The magnitude of the dollar's depreciation against other currencies could be outpaced by the dollar's fall against real assets.

Each sector of the bond market entails risk. The guarantee on Treasuries, TIPS and Government Bonds is to the timely repayment of principal and interest. Shares of mutual funds that invest in them are not guaranteed. Mortgage-backed securities are subject to prepayment risk. With Corporate bonds there is no assurance that issuers will meet their obligations. High-yield bonds typically have a lower credit rating than other bonds. Lower rated bonds generally involve a greater risk to principal than higher rated bonds. Investing in non-U.S. securities may entail risk as a result of foreign economic and political developments; this risk may be enhanced when investing in emerging markets. In an environment where interest rates may trend upward, rising rates will negatively impact most bond funds, and fixed income securities held by a fund are likely to decrease in value.

This commentary is presented only to provide information on investment strategies and opportunities. The material contains the current opinions of the author, which are subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.

PIMCO Funds & Allianz Funds are distributed by Allianz Global Investors Distributors LLC, 1345 Avenue of the Americas, New York, NY 10105-4800, www.allianzinvestors.com, 1-888-877-4626 © 2009.

Investment Products: Not FDIC Insured I May Lose Value I Not Bank Guaranteed