
Your Global Investment Authority



PIMCO 2011 Secular Forum Speakers

The Rt. Hon. Gordon Brown, British Member of Parliament; former Prime Minister (2007–2010) and Chancellor of the Exchequer (1997–2007); author of “Beyond the Crash: Overcoming the First Crisis of Globalization”

Mark Halperin, *TIME* magazine editor-at-large and senior political analyst; author of the *New York Times* #1 best-seller “Game Change: Obama and the Clintons, McCain and Palin, and the Race of a Lifetime”

Dambisa Moyo, economist; former consultant to the World Bank; author of two best-sellers, “Dead Aid: Why Aid Is Not Working and How There Is a Better Way for Africa” and “How the West Was Lost: Fifty Years of Economic Folly – and the Stark Choices Ahead”

Gillian Tett, U.S. managing editor of the *Financial Times*; winner of the British Press Awards 2009 Journalist of the Year; columnist; author of “Fool’s Gold: The Inside Story of J.P. Morgan and How Wall St. Greed Corrupted Its Bold Dream and Created a Financial Catastrophe”

Navigating the Multi-Speed World

Colleagues from around the world gathered last week in our headquarters in California for a PIMCO tradition that is almost 40 years old: Our annual Secular Forum – an occasion when we temporarily leave behind high frequency and cyclical issues and, instead, actively debate what the next three to five years hold for the global economy and markets.

As many of you know, the Forum is one of the pillars of our investment process. It speaks to both *what* and *how* we think. It reduces the risk of cognitive capture and active inertia. And the output informs in multiple ways our approach to delivering value to our clients around the world.

Once again, we had the privilege of listening to four excellent outside speakers (see left). They were chosen for their expertise, experience, and diverse perspectives and frameworks; and they did not disappoint. Their presentations were thoughtful, stimulating and entertaining.

We also maintained the wonderful custom of giving the stage to our brand new hires to hear their views on what the firm should be thinking about in defining its broad course for the next few years. They too excelled, providing great insights and comprehensive analysis.

All this encouraged a wide-ranging and, at times, heated discussion that encompassed many issues – economic, political, demographic, scientific and social. Remember, PIMCO’s Secular Forum takes a “*long term*” view (which, for market participants, means a three- to-five-year

“This policy initiative – to deliver “good” asset price inflation so that people would feel richer and spend more – also delivered “bad” inflation.”

horizon). It is *global* in nature. It is about what is *likely* to happen rather than what *should* happen. And its main characterization is, of course, re-examined periodically during the year as new information and analysis become available.

My objective here is to try to summarize for you the key issues that emerged during 2½ days of discussion, and several months of preparation and analysis. While I regrettably recognize that I will fail to do justice to the depth of the insights and interesting exchanges, I hope to capture for you the main points and some of the nuances.

That’s not all I am hoping to do. As Bill Gross often points out, we are not in the business of buying and selling GDP notes around the world. Instead, we invest across the capital structure, and across borders and sectors. So it is about all types of bonds and equities, commodities, currencies, volatility, etc. . . . Accordingly, the discussion will also be linked to broad principles underpinning investment positioning over the secular period.

This linkage of the Forum to our secular investment strategies is very important. It speaks directly to key multi-year themes and related guard rails. Together with cyclical, structural and tactical considerations, this determines the way we position the pensions, investments and savings which you have entrusted to us to manage on your behalf.

While this is the main way in which the Forum impacts our daily delivery of value to you, it is not the only one. It also influences how we approach client interactions, product/solution design, thought leadership, and business management. But these are for another occasion.

With this preamble, the rest of this summary note is organized in three main sections: the context for the discussion, the main findings, and the investment implications.

The Context

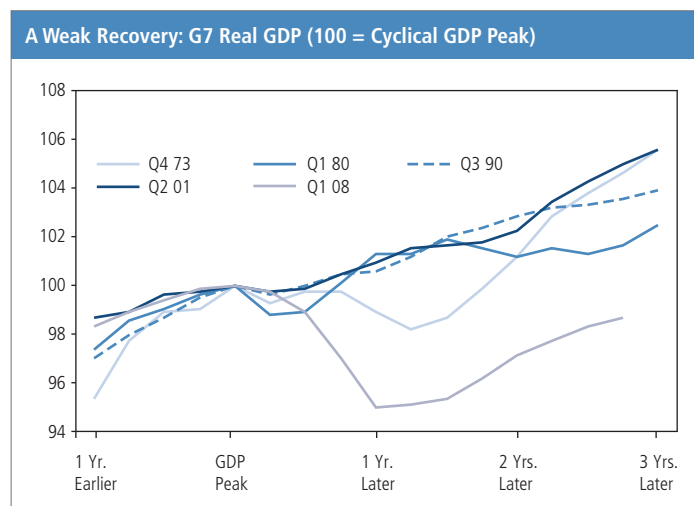
In the two Secular Forums that followed the collapse of Lehman Brothers,¹ we postulated that the world would have difficulties resetting in the traditional cyclical manner. Instead, it faced a protracted journey involving major, multi-year national and global re-alignments; and the destination would differ in some important respects from recent historical precedents.

We attempted to capture all these complex issues by the simple phrase “a bumpy journey to a new normal.” We argued that the process would involve two distinct sets of dynamics: *Advanced countries* – and particularly the finance-dependent ones (and, importantly, the U.S.) – would experience unusually sluggish economic growth, persistently high unemployment, public debt and deficit issues, increased regulation, and continuous pressures for private sector deleveraging. Meanwhile, *emerging economies* would maintain their development breakout phase, registering high growth rates and continuing to close the income and wealth gap relative to advanced economies.

In painting this medium-term picture, we also acknowledged issues of stability – or to be more specific, potential instability. Indeed, the image that came to our mind last year was that of a car traveling on a bumpy road, to an uncertain destination, and driving on a spare tire.

Part of the three- to five-year secular horizon has elapsed and developments have been consistent with this new normal characterization. For example,

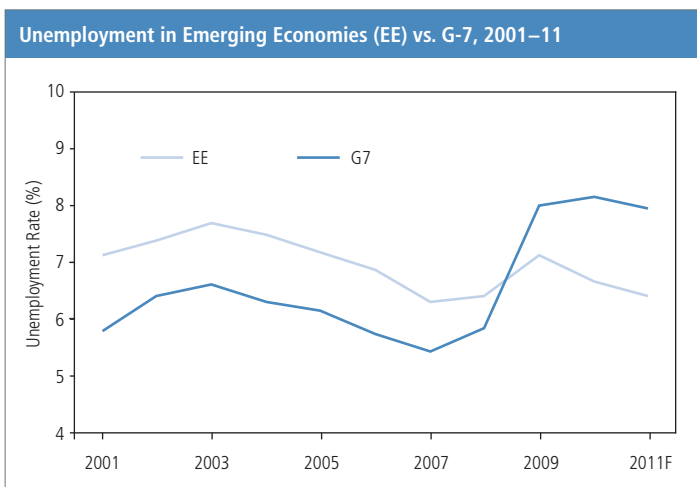
- The ongoing G-7 recovery is relatively sluggish, both in overall terms and relative to history (Figure 1);



Source: Haver Analytics, IMF (International Monetary Fund)

Figure 1

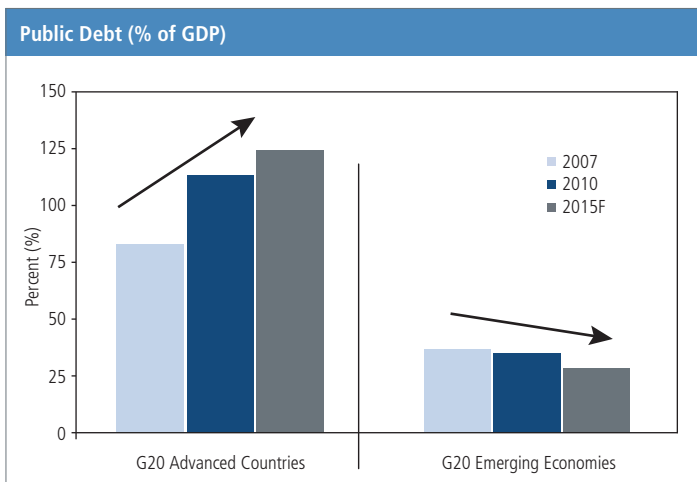
- The unemployment rate in the G-7 has surged and, despite a fall in the labor participation rate in some countries, now exceeds that of emerging economies (Figure 2);



Source: Haver Analytics

Figure 2

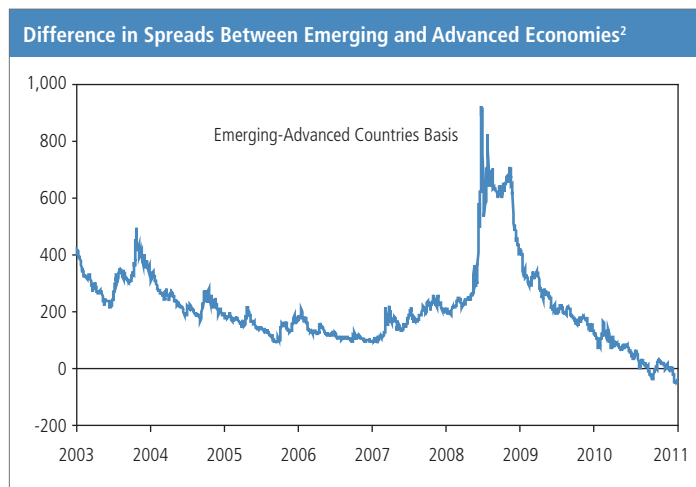
- Deficit and debt indicators have worsened significantly, in absolute terms and relative to emerging economies (Figure 3); and, in a major change for those that remember the old days,



Source: International Monetary Fund

Figure 3

- The average market risk spread on advanced economies now exceeds that on emerging economies (Figure 4).



Source: PIMCO

Figure 4

These realities are playing out notwithstanding bold policy reactions in advanced countries aimed at mitigating them and delivering a more “normal” recovery. Indeed, for most of the post-crisis period, policymakers (particularly in the U.S.) have been fixated – and understandably so – on stimulating growth through aggressive fiscal and monetary policies. Indeed, some policymakers have even embraced explicit initiatives to boost asset prices, driving a significant wedge between economic fundamentals and turbo-charged asset valuations.

This is not just about the dramatic measures undertaken in 2008–09 to avoid a global depression and normalize markets ((such as America’s QE1 (Quantitative Easing 1), TARP (Troubled Asset Relief Program), and an almost \$800 billion fiscal stimulus)). It is also about what followed – be it QE2 (Quantitative Easing 2), the December 2010 U.S. fiscal package or Europe’s willingness to use every balance sheet available to bail out three of the peripheral economies (Greece, Ireland and Portugal).

While the impact on Main Street in America and Europe has repeatedly fallen well short of policymakers’ stated expectations, the unconventional policy actions were consequential for markets. In particular, they suppressed real interest rates, thus pushing investors all

“Balance sheets, both across and within economies, are still out of equilibrium in what remains an excessively asset-based global economy.”

over the world out the risk spectrum and contributing to an impressive rally in global equities, emerging market bonds and currencies, and high yield and investment grade corporate bonds.

Yet this policy initiative – to deliver “good” asset price inflation so that people would feel richer and spend more – also delivered “bad” inflation as commodity prices surged, imposing a tax on both input prices and consumers. As a result, policymakers risk being sucked in even deeper into a “portfolio management conversion” – now trying to differentiate between good and bad asset price inflation.

While on the topic of collateral damage and unintended consequences, the last 12 months also saw a series of improbables – if not unthinkableables – become reality, thus speaking to the bumpiness of the journey and the different destination.

S&P placed America’s sacred AAA rating on negative outlook. The possibility of default and debt restructuring in Europe’s periphery became a topic of active discussion notwithstanding the core’s willingness to make fiscal transfers and also contaminate the balance sheet of the ECB (European Central Bank) and IMF (International Monetary Fund). Commodity prices surged despite sluggish growth in advanced economies. And the dollar depreciated sharply even with the uprisings in the Middle East, Europe’s debt crisis, Japan’s tragic calamities, and emerging economies’ attempts to stop the appreciation of their currencies.

Fortunately, these were not the only notable developments. The global economy has progressed in its post-crisis healing, albeit in an uneven and costly manner. Across geographical borders, some sectors (led by multinationals) became stronger than they were before the crisis; witness their powerful balance sheets, large cash holdings, and record profit levels. And unemployment in some countries reached lows not seen for years (e.g., Germany) and, in some cases, recorded history (e.g., Brazil). And millions of people continued to pull themselves out of poverty in China, India and other emerging economies.

Finally, the role of social media and other communication advances (such as cloud computing) has also been notable. On the economic front, these ever growing phenomena have reduced certain input prices and barriers to entry (e.g., through the pooling of IT resources). Socially, they have

helped lower coordination problems in repressed societies, creating dramatic tipping points (e.g., the role of Facebook and Twitter in the Egyptian and Tunisian revolutions). And politically, they have widened the gap between struggling “old media” and surging “new media,” adding to political polarization due to ever growing blood sport tendencies and more embedded tribe-like behavior among political partisans.

The Main Findings

So we held our discussion against the backdrop of a multi-speed world that, to use Neal Soss’s (Credit Suisse) phrase of a few months ago, was “cyclically recovering but structurally impaired.” Moreover, as Martin Wolf (a previous Secular speaker) noted in his April 20th column in the *Financial Times*, it is a world in which policymakers (and, we would add investors) “confront a host of complex and interlocking challenges: fiscal and monetary normalization in advanced countries; fixing the overhang of excess debt and financial fragility in those economies; managing the overheating in emerging economies; adjusting to big shifts in relative prices and rebalancing the entire pattern of global demand. Nothing that is now happening suggests any of this will be managed competently, let alone smoothly.”

Given this context, it is hardly surprising that our 2½ days of discussions pointed to many currents and cross currents operating in today’s global economy. Indeed, it is the best of times for “two handed” economists.

Looking forward, there are some encouraging signs that speak to an accelerated healing of the global economy over the next three to five years, its growing resilience and, within this, the ability to remove in an orderly fashion the exceptional support provided by unconventional policy actions. There are also signs that suggest that emerging economies are well anchored on their historical development breakout journey; and that China, in particular, will be able to navigate what is inherently a complicated middle income development transition.

Unfortunately, there are also signs that point to an uneven and faltering global recovery for the next three to five years. Think of the debt overhangs in advanced economies where projected rates of economic growth are not sufficient to avoid mounting debt and deficit problems. Some are already flashing red, and they will force even more difficult decisions between restructuring and the massive socialization of losses

(e.g., Greece). Others are flashing orange (e.g., the U.S.), and already require future sacrifices, most likely through a combination of higher inflation, austerity and, importantly “financial repression” (i.e., governments seeking to impose on savers negative real rates of return).³ Needless to say, demographic transitions, commodity constraints and geo-political uncertainties complicate all this.

We covered many other examples of currents and cross currents. While they are all interesting, their existence per se is indicative of something much more consequential – namely, that *it is still about balance sheets* (companies, governments, and households). And this is where key judgments must be, and were made during our discussion.

Balance sheets, both across and within economies, are still out of equilibrium in what remains an excessively asset-based global economy. This raises the question of when and how the rebalancing will take place (voluntary versus involuntary); and it speaks to levels, composition, and implications for existing “contracts.”

Despite the wrenching global financial crisis, the world has seen little meaningful reduction in the size of the excess liabilities accumulated during the “Great Age” of leverage, debt and credit entitlement. Rather than be addressed in a convincing manner, most of the excess liabilities have simply been shifted around the system, and importantly to public balance sheets and taxpayers.

Sectors vary wildly in the robustness of their balance sheets. Some are strikingly healthy (e.g., multinationals and consumers in emerging economies), having the wallet but not the will to spend; some are healing (e.g., several large banks that have enjoyed the benefits of capital injections, government guarantees and steep yield curves); and others are deteriorating as existing debt is compounded by large deficits (governments in several advanced countries).

Given levels and composition, there is little doubt in our minds that many long-standing contracts will come under pressure over the next three to five years.

By targeting negative real interest rates (directly and through regulatory steps), policymakers will pursue financial repression that undermines the “real return” contract that savers expect. A variety of social contracts – e.g., health and pension entitlements, as well as unemployment

benefits – are already stressed and face even greater strain. And, at the international level, several implicit contracts will be questioned given the gradual erosion in the standing of the public goods supplied by America (including the dollar, the reserve currency).

Baseline

We do not expect policy makers and politicians to show the resolve required to boldly address the structural problems that currently hamper the global economy. Some of them are rendered complacent by an overwhelming belief in the inherent resilience of certain economies. Others feel that gradualism is sufficient, or prefer to simply kick the can down the road hoping for some immaculate improvement. And most are paralyzed by the economic and political challenges associated with a shift from a cyclical/liquidity approach to also a structural/solvency one. Finally, there is the political dimension characterized by extreme polarization, large anti-incumbency feelings, and uneven participation.

This is also a world of weak global governance. As such, win-win cooperative solutions cannot be assured; nor can they be imposed by multilateral bodies (be it the G-8, G-20 or the IMF).

All this speaks to the continuation of the muddle (or, perhaps more accurately, hobble) through scenario for the foreseeable future. This is a world in which policymakers eschew breakthroughs, opting instead for gradualism and “mini bargains” in the hope that they are enough to avoid really bad economic and financial outcomes. It is a world that heals slowly and unevenly, and remains structurally impaired. It is a world where several governments in advanced economies (and the U.S. in particular) opt for financial repression and mild inflation as the major way to accommodate their deteriorating debt dynamics. And it is a world that continues to transition slowly, and in a rather messy and uncoordinated fashion, from a predominantly uni-polar character to a multi-polar one.

To the extent that this hobble through scenario holds, the next three to five years will be characterized by the same multi-speed dynamics we have seen recently. Specifically:

- Advanced economies will face sluggish (call it 2%) growth and persistently high unemployment that becomes more structural (and

“We see a hobble through scenario for the foreseeable future. It is a world that heals slowly and unevenly, and remains structurally impaired.”

therefore protracted) in nature. Already large disparities in income and wealth will continue to worsen, amplified by higher inflation and financial repression. And debt and deficit concerns will not go away, with the virtual certainty of at least one (and probably more) sovereign debt restructuring in Europe.

- Emerging economies will achieve higher growth (in the 6% range), and their income and wealth levels will continue to converge to those of advanced economies. Millions more will escape poverty. But this will not be without its own set of challenges, including recurrent inflationary concerns as well as complicating surges in capital inflows that will lead to increased policy experimentation.
- Sovereign creditworthiness will continue to diverge, with the deterioration in advanced countries contrasting with a continued improvement in the emerging world as a whole. This will render even more obsolete the traditional interest/credit rate distinction between these two groups of countries (Figure 5) – a distinction that, even today, still underpins too many parameters of the financial service industry (including backward looking benchmarks and investment guidelines – more about this later).

- Inflation convergence – between high headline and low core rates, as well as between high emerging and low advanced country rates – will occur at levels that are higher than currently anticipated.

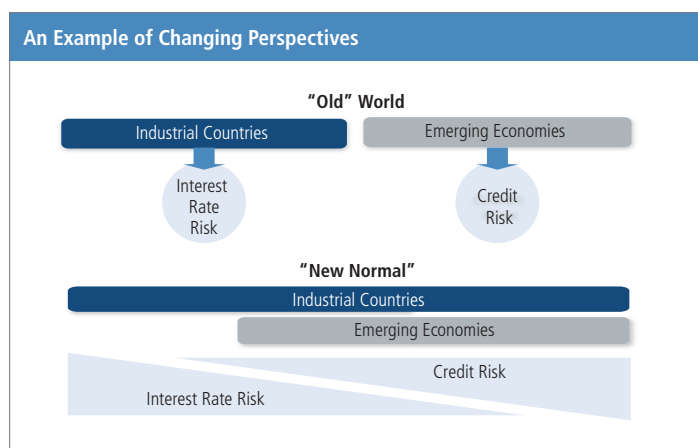
Risk Scenarios

This hobble through world is a reaffirmation of the concept of a bumpy journey to a new normal. Be it China, Europe, or the U.S., it presumes that policymakers and politicians can continue to dominate economic and market fundamentals. It is also a baseline that is subject to two-sided tails that should be kept front and center on our secular radar screens; and these tails could well get fatter as the years pass.

The baseline can tip into a better global equilibrium (“the right tail”) through a series of “grand bargains.” Think of three in particular. First, the U.S. having a “sputnik moment” where serious structural reforms – focused on re-aligning balance sheets over the medium term, enhancing employment creation, and improving international economic competitiveness – result from a sense of national unity, common purpose, and shared sacrifice. Second, Europe confronts its “moment of truth” and course-corrects the setup of the Euro-zone to enable both debt sustainability and high economic growth. Third, emerging economies actively unleash their consumers, thus ensuring that their systemic impact is felt through both production and consumption.

While the probabilities for these grand bargains have increased in recent months, they are still far from dominant. Accordingly, rather than drive at this stage the baseline for the next three to five years, the best that they can do is offset pressures for a less favorable global outlook.

These pressures, which are multifaceted, speak to the unfavorable risk scenario (or “left tail”). There are limits to how long excessive liabilities can simply be shifted around the system. You cannot address solvency concerns by piling new debt on top of old debt. Excessive income and wealth inequalities eat away at the fabric of societies. Persistent joblessness undermines productivity and skills, and can also turn part of the youth from being unemployed to being unemployable. Finally, policymakers cannot kick the can down the road forever, especially as both policy effectiveness and flexibility are eroding and the risks/reality of collateral damage and unintended consequences grow day in and day out.



Source: PIMCO

Figure 5

Remember, the world is interconnected as a system but is increasingly fragmented in terms of cognitive recognition and policy coordination. Importantly, social cohesion is uneven across countries at a time when difficult decisions have to be made about entitlements and a related need to allocate and tolerate the disappointments associated with broken contracts.

Investment Implications

Our discussions point to five important considerations for the three- to-five-year guard rails for investment strategies.

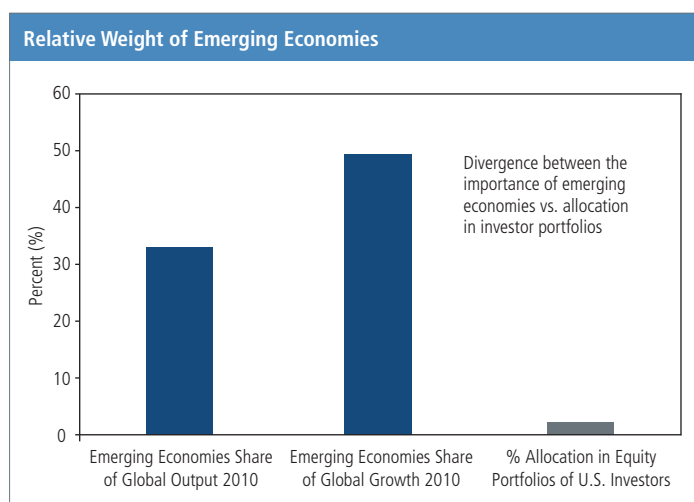
First, there is a limit to the amount of investment returns that can be brought forward from the future, especially in advanced economies. Yes, the authorities have succeeded in driving a wedge between sluggish and uneven fundamentals and high investment returns. In the process, investors *as a group* have essentially borrowed returns from the future. But the thickness of this wedge is limited by the extent to which real rates have already been compressed.

Second, secular baseline portfolio positioning should incorporate some key principles impacting both risks and returns: e.g., minimize exposure to the negative impact of financial repression; hedge against higher inflation and currency depreciation; and exploit the heightened differentiation in balance sheets and growth potentials.

Third, differentiation within asset classes, including careful security selections, will remain key. Global yield curves will be steeper than historicals, with duration/roll down at the front end dominating. Government bonds should be influenced by the exact country mix of budgetary austerity, creditworthiness, financial repression and monetization. Corporate exposures, through both stocks and bonds, should be heavily impacted by top line growth, cash holdings and pristine balance sheets. Most tradeable sectors are likely to dominate non-tradables and, within the latter, high dividend stocks will lead growth in advanced economies (and vice versa in developing). Foreign exchange positioning will be key, favoring undervalued/fair valued emerging currencies supported by strong balance sheets and where capital controls tend to be ineffective. Supply-constrained/store of value commodities will likely do well, but in the process also demonstrate large volatility on account of regulatory reactions (real and perceived).

Fourth, investors will need to show significant agility given the fatness of the two-sided tails just discussed. This relates to the scaling of positions and the assessment of correlated risk factors. It also speaks to cost effective tail hedging given the investment implications of the tails.

Finally, the next few years will require investors to upgrade and retool a whole set of conceptual and operational approaches that have served us well in the past but are less relevant going forward and, in some cases, could even be dangerous. It is not just about the country distinctions mentioned earlier. Ongoing changes in the global economy are still inadequately captured in the construction of traditional indices, asset allocation methodologies and investment guidelines. As an illustration, conceptual constructs, including market cap approaches, will likely prove less useful; and a sustained effort will be needed to counter well-entrenched home biases (e.g., Figure 6) that result in asset allocations that are increasingly inconsistent with domestic and global re-alignments.



Source: International Monetary Fund

Figure 6

Concluding Remarks

With the world continuing on its bumpy journey to a new normal, there certainly is a lot happening in the global economy that is of direct, and unusual relevance for markets and for the way we position your portfolios. This is the nature of multi-year re-alignments, especially when

they take place concurrently at both the national and global levels. They are messy and uneven; they turn parameters into variables; and, especially when it comes to policies and politics, they change the balance of benefits, costs and risks (to use a phrase from Fed Chairman Bernanke).⁴

These re-alignments become even more interesting when multi-speed growth, inflation, and credit dynamics are in play – as is the case today. Critically, they also become much more complex when the related balance sheet repairs proceed in a slow and uneven fashion.

Expect us to do our utmost to continue to analyze well these multi-year, multi-speed dynamics; and to properly reflect them in everything that we do for you – from secular investment positioning to the design of investment solutions, and from client servicing to business management.

The world will remain an unusually fluid place. By looking forward and retaining our culture of “constructive paranoia,” we will strive to ensure that your portfolios benefit from change, rather than fall victim to it.

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¹See PIMCO Secular Outlook; “Driving Without a Spare,” (May 2010)
<http://www.pimco.com/EN/Insights/Pages/Secular%20Outlook%20May%202010%20El-Erian.aspx>
See PIMCO Secular Outlook; “A New Normal,” (May 2009)
<http://www.pimco.com/EN/Insights/Pages/Secular%20Outlook%20May%202009%20El-Erian.aspx>

²The difference in spreads shows the 5 yr on-the-run CDX.EM index spread (EM) minus the proxy 5 yr SovX Western Europe index spread. PIMCO simulated the proxy 5yr SovX Western Europe index spread by averaging 5yr CDS for the 15 countries that constitute the Markit iTraxx SovX Western Europe index. A positive number implies that EM sovereign spreads are greater than DM sovereign spreads. A negative number implies that EM sovereign spreads are less than DM sovereign spreads, therefore implying that the market is pricing lower credit risk for EM than for the specified basket of developed markets.

³See Investment Outlook: The Caine Mutiny (Part 2) (May 2011)
<http://www.pimco.com/EN/insights/pages/the-caine-mutiny-part-2.aspx>

⁴See speech by Ben Bernanke at the Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyoming

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There is no guarantee that these investment strategies will work under all market conditions and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market.

The Markit iTraxx SovX Western Europe Index is based on the credit spread of 15 equally weighted sovereign constituents from an 18 name universe comprising Eurozone countries that are traded on Western European documentation plus Denmark, Norway, Sweden and United Kingdom. The Markit CDX.EM.15 Index is based on the credit spread of a basket of sovereign credit default swaps from a group of 15 Emerging Markets countries.

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