PIMCO 2013 Secular Forum Speakers

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New Normal … Morphing

Maintaining an approach that has served PIMCO’s clients well for four decades, our investment professionals gathered in Newport Beach last week for three days to discuss the three-to-five year outlook for the global economy and markets. Again, we were privileged to hear the insights of global thought leaders and experienced practitioners from outside PIMCO (see box), as well as our new (and really impressive) class of MBAs and PhDs.

As you can imagine, we covered quite a few themes: from the hyperactive role of central banks to quite dysfunctional politics, from increasingly influential demographics to unusual economic and financial configurations, and from exciting innovations to disturbing income inequalities and social tensions. Yet, with the anchoring role of PIMCO’s 2009 concept of a multi-speed New Normal (yes, it has played out as anticipated), we managed to converge on a three-five year outlook for the global economy – not as an end in itself but, rather, as a means to specify longer-term investment themes.
Think of this annual “Secular Forum” as providing the medium-term guardrails for how, where, why and when we invest the funds that you have entrusted to us.1 It informs and influences the positioning of our commodity, currency, equity, fixed income and multi-asset strategies (in terms of beta and alpha generation, as well as risk management approaches). Needless to say, the findings will be supplemented by the conclusions of our next quarterly Cyclical Forums, the four-times-a-week meetings of the Investment Committee, and high-frequency interactions among colleagues in our 13 offices around the world.

I must admit that, going into this year’s discussions, I found the context even more challenging than usual. Indeed it was the most complex since I first joined PIMCO in 1999.

This complexity is not just due to a global economy in the midst of multiple historical realignments. It is also because highly experimental central bank policies have disconnected most asset prices from the complex ecosystem. Fortunately, I was helped by insightful presentations, robust discussions and remarkable inputs from talented colleagues. So, starting with a bit of context, here are our major findings and broad investment implications.

Context

A prior Secular Forum concept – that of a “New Normal” involving unusual and persistent multi-speed dynamics within and across countries2 – again proved valuable in anchoring our starting point. Indeed, the concept has become so mainstream by now that, just last month, Christine Lagarde, the managing director of the International Monetary Fund, used a “three-speed world” to frame the conversation for officials gathering in Washington, D.C., for their semiannual policy discussions.3

A relatively robust set of fast-growing emerging countries (led by China) has continued to act as the locomotive for the global economy. From a GDP perspective, they have been compensating for the slowest Western economies mired in unsatisfactory growth – first Japan and now, to a greater extent, a growing part of Europe. In the middle is a healing U.S. economy where an increasing number of sectors have rehabilitated their balance sheets but have yet to collectively reach escape velocity.

This elegant “three-speed” characterization featured prominently in our discussion. And the critical question that kept on surfacing was if, when and how it would transition in the next three-five years, with particular emphasis on growth dynamics and related aspects of financial stability, cross-country interactions, and the impact of inequality and political dysfunction (see Figure 1 for an illustration of the major potential medium-term handoffs).

FIGURE 1: MULTI-SPEED NEW NORMAL: DOES IT CONTINUE OR DO CONSEQUENTIAL HANDOFFS OCCUR WITHIN THE NEXT 3-5 YEARS?

<table>
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<th>From...</th>
<th>To genuine, inclusive and sustainable growth; or growth shortfalls?</th>
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<td>Assisted growth</td>
<td>Purchased financial stability (experimental central banking)</td>
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<td>“Chamerica” and eurozone/European Union</td>
<td>Growing inequality and political dysfunction</td>
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| To structural stability; or renewed asset price bubbles? | To a more stable political, institutional and social context; or to destabilizing sociopolitical and geopolitical risk?

Needless to say, the role of central banks came up a lot in our analysis. By venturing deep into experimental policy territory, and by remaining there for quite a while, central banks have tried to support growth and counter financial instability, thus buying time for economies to heal endogenously and for politicians to deliver on their policy responsibilities. In the process, they have inserted a remarkable wedge – a disconnect – between market prices and underlying economic and financial fundamentals.

Despite their innovative and courageous efforts, central banks are still unable to deliver sufficiently robust growth and jobs to Main Street. But they have been investors’ best friends.
Their unprecedented policy activism (including, most recently, Japan’s boldest post-war economic policy experiment) has – to use Bill Gross’s southern Californian analogy – induced the vast majority of investors to grab their risk surfboards and ride a large and growing wave of global liquidity.

Investors are enticed to take more and more risk at ever more elevated prices. Most see no need to kick out of the wave anytime soon; and quite a few believe that, if it eventually breaks, it will do so gently, delivering investors to a world where improving fundamentals validate and push even higher asset prices initially rendered artificial by unconventional policy actions.

By seeking to lessen the twin problems of deficient aggregate demand and structural impediments, and by financing debt problems, central banks have delivered investors a down payment on future growth and future returns. Well, that is the hope and intention. But if growth fails to materialize over time, reality will snatch back the returns from investors in the period ahead.

Central bank activism has also been beneficial for banks. The vast majority of U.S. banks have regained a firmer footing, raising capital, cleaning up their balance sheets and starting to realign their business models. Progress has been slower in Europe. There, unusual central bank activism has just reduced (though importantly) the left tail risk of severe disruptions. Most banks still have to adjust balance sheets, business models and mindsets.

Large companies have responded differently to this multi-speed reality. Showing less exuberance and confidence than financial investors, they have yet to expand aggressively. Instead, they have remained quite focused on cost control. Meanwhile, M&A (mergers and acquisitions) activity has been largely limited to defensive transactions – those that provide cost synergies as opposed to platforms for stepped-up investments in new plants, equipment and hiring.

Smaller companies, and particularly those unable to tap pockets of robust demand around the world, have faced greater challenges. Having less operational agility and depending on credit from a largely hesitant banking system, they have struggled more to maintain adequate top-line revenue growth, profitability and balance sheet resilience. Households also vary tremendously. In the emerging world, the remarkable social transformation has continued, with millions more being pulled out of poverty (especially in China). This is unfortunately not the case in the West. While most rich and globally educated individuals here have been able to maintain income and wealth growth, the middle class continues to be squeezed and lower-income households have struggled as too many lack jobs and have been forced to draw upon dwindling savings.

Most Western governments have seemed less able and less willing to compensate with stepped-up government spending and redistribution policies. Balance sheets and mindsets are still encumbered with memories of large deficits and controversial bailouts. And economists are too divided to provide governments with the analytical air cover that they desperately need.

Given powerful and pervasive central bank influence, markets have not reflected in a meaningful sense this diverse ecosystem. Instead, price signals and market functioning have been distorted by unusual policy measures, and resource misallocation has become a threat.

It has been less than five years since excessive risk-taking, debt accumulation and credit entitlements pushed the global economy to the brink of a depression. Yet there are already concerns about renewed financial bubbles and the return of irresponsible financial behavior – all this at a time when governments and central banks have fewer tools at their disposal to deal with the threat of another financial crisis, and when global policy coordination has weakened to a worrisome point, especially relative to the shared challenges and responsibilities.

**Outlook**

Against this complicated background, our deliberations focused on the outlook for the three groups of countries (low, medium and high speeds) and various segments that cut across them. We also addressed the even more intriguing “adding up” questions – including the manner in which the global system accommodates all this unusual diversity in the years ahead.\(^4\)
Whether due to insufficient policy tools or politicians’ misunderstanding of the underlying dynamics and implications, the New Normal is now looking at multiple possibilities of what the British would call a “T-junction” – where the current road eventually ends, giving way to one of two contrasting outcomes. In economic terms, the current setup would yield either to a sunny road (in terms of growth and financial rebalancing) or to a stormy one (countries and segments competing for a smaller pie while the political system finds it hard (yet necessary) to allocate and deal with burden sharing).

As stable as the current course of action looks, it may in fact become untenable at some point in the future. As illustrated in Figure 2, this “stable disequilibrium” suggests two future possibilities: (i) driven by endogenous economic/financial healing and political renewal, the New Normal would eventually hand off to high sustainable and inclusive growth that facilitates a safe deleveraging in the West and accommodates the growing systemic role of the emerging world; or (ii) it transitions to even lower growth that complicates the West’s (actual and potential) debt traps, causes financial instability, fuels greater social tensions, worsens political dysfunction and encourages beggar-thy-neighbor approaches at the global level. In the interim muddle through, the slowest economies and vulnerable sectors elsewhere face a growing risk of “zombification” (as one of our speakers put it).

The critical importance of growth was stressed over and over again as we explored these possibilities and the related key question for investors: If, how and when would improved fundamentals validate artificial prices in a globally consistent and sustainable fashion?

Going back to the three-speed characterization, growth is needed to overcome the current malaise in low- and medium-speed countries and among vulnerable segments in the higher-speed group; and it must be maintained in the high-speed economies as they deal with their own internal and external realignments.

For investors, such high, sustainable and inclusive growth would not only translate to a general validation of current risk asset prices but also reduce the probability and severity of disruptive haircuts – all accentuated by the real possibility that, within our three-five year secular horizon, central banks are likely to become less effective in buying time with their “pragmatic experimentation,” especially as the risk of collateral damage and unintended consequences mounts.

Yes, this is what should (and could) happen – namely, renewed national and global efforts to put in place the conditions for growth, financial stability, reduced inequality and orderly global rebalancing. But what is likely to happen? Here, we converged to the following eight medium-term themes among the many that were discussed.

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**FIGURE 2: STABLE DISEQUILIBRIUM DYNAMICS: HOW DO THEY PLAY OUT?**

- **Muddle through**
  - “Zombification”
  - “Lost decades syndrome”; deflationary contraction
  - Stagflation/inflationary contraction
  - Sociopolitical tensions
  - Renewal
  - Endogenous healing, escape velocity, and safe deleveraging

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First, the lineup for the large economies is clear. To illustrate, we detailed a ranking for systemically important and investible countries along a spectrum anchored, at one end, by those facing the shortest journey to the “T” and the most contrasting journey out of this junction and, at the other end, by those with much longer journeys to a less stark junction.

For example, we believe that peripheral European countries (with dismal growth, alarming unemployment and fragile debt dynamics) are closest to the neck of the “T;” and they will exhibit even more trends reminiscent of the emerging economies of the old crises days. Then there is a Japan in the midst of an historical high-risk/high-return policy regime change. France, India and the U.K. follow; and then the U.S., Brazil, China and Germany. Using this sovereign spectrum, one can construct a framework that reflects the different initial conditions facing various economic segments and the impact of socio- and geopolitical factors.

Second, and related to the first factor, growth dynamics are notably heterogeneous and most growth models need to evolve. In the West, endogenous healing and significant short-term innovation accelerators are limited mainly to the U.S. – albeit a country still confronting headwinds from incomplete deleveraging and a dysfunctional Congress. Others face stronger self-made and exogenous headwinds. And some lack growth models altogether, and have low probability of successfully implementing new ones in the next three to five years.

This issue of growth models (as distinct from just growth) is an important one. Whether it is China with its transition from export-led to consumption-led growth, or the West in the aftermath of the global financial crisis, many countries need to evolve their engines of job and income generation. And while central banks are doing their utmost to buy time, their involvement can inadvertently push countries back toward old and exhausted growth models.

Third, look for central banks to maintain their pragmatic experimentation mode. Over the next three to five years, instruments will evolve as more institutions around the world feel compelled to follow the Fed in targeting growth and jobs more explicitly. From supporting SMEs (small- and medium-sized enterprises) and broadening the set of assets they purchase to deepening fiscal/monetary compacts (effectively becoming de facto fiscal agents), some of their involvement will remain a meaningful influence on markets. As investors, we need to pay close attention to the range of “benefits, costs and risks” in what is bound to be an evolving balance.

We were reminded that it is not just about the content of central bank policy. Their operational mode will vary as they temper their actions with their desire to maintain discipline and conditionality on others. It will not be a smooth process. As an example, expect the European Central Bank to swing from a “WIT” (whatever it takes) approach to more muted activism – due to moral hazard concerns in Frankfurt and elsewhere – then back again to WIT … and so on.

Fourth, unless there is a growth revolution, haircuts will increase during the three-to-five year secular horizon. As Bill detailed in his latest Investment Outlook, investors should realize that there is quite a large range of haircuts that can eat away at their capital.

The less visible form – financial repression – is certain to continue. In some parts of Europe, it will likely be accompanied by more explicit forms of debt restructuring and confiscation. Indeed, the further Europe gets away from the most acute phase of its systemic crisis, the wider the set of possible burden sharing in the weakest segments. And this may become even more unpredictable.

Fifth, be sensitive to the role of political and institutional factors as they act either as accelerators of good outcomes or major disruptors. The key question here is not whether political and institutional responses need to catch up with the realities of today’s fluid economic situation. They do, both at the national and global levels. The question, and it is a consequential one, is whether we will get the necessary renewal process.

It is sad to admit but, absent much greater social pressures (which no one wishes), we see little basis for predicting a major political and institutional revival over the next three-to-five years in the West. This is not to say that progress will not be made. Indeed, we have already seen notable changes and initiatives in Europe. Rather, as one speaker reminded us, “Political time is quite different from economic and market time.”
This brings us to our sixth insight: **Social issues will play a more important role in determining the West’s medium-term economic outlook.** From well-developed welfare systems and family networks to initial high levels of wealth, these are reasons why greater social unrest has not followed the dramatic collapse in GDP in some European economies, along with an alarming spike in total and youth unemployment. Yet, already, elections have signaled dissatisfaction with incumbents, traditional parties and, in some cases, the system itself. The politics of austerity are evolving. And we face some major elections in the period ahead, including in Germany (this year) and what may finally be a consequential ballot for the European parliament (next year).

Seventh, **global and regional interactions are more likely to complicate than reconcile national politics and policies.** We see it already in Europe and in some Asian reactions to Japan’s policy regime shift.²

So while it is great news that the central core of the international monetary system is steadily healing (the U.S., which is also re-engaging on the international trade front, including via Trans-Atlantic and Trans-Pacific initiatives), the system as a whole still struggles with the trio of deficient aggregate demand, structural impediments and inadequate redistribution mechanisms. The negative employment aspects of certain innovations and demographic trends are also not helping.

Finally, **the important focus on macro should not blind us from consequential sectoral stories.** From the shale energy revolution to digitalization and 3-D printing, there are some really exciting investible stories – both as standalones and in their role in reindustrialization and disruptive transformations (including some “winner-take-all“ aspects).

I suspect that many of you are also interested in our big macro calls. So, put all this together in PIMCO’s medium-term analytical blender and this is what you get for the next three to five years:

- **In Europe,** with the lack of a comprehensive resolution, the collapse of the single currency will remain conceivable and possible, though not a dominant probability. The more immediate threat is a process of “zombification” (with the balance of risk tilted to the downside), coupled with additional debt restructurings (some of which may not be decisive enough to lift growth-inhibiting debt overhangs).
  - The U.S. will continue to heal but maintain a cruising-growth speed that is not much greater than 2% on average, with concerns over subpar growth (relative to potential) broadening to encompass worries about the level and composition of potential.
  - Japan will have an initial growth surge but its sustainability will be challenged by challenging structural reforms and an increasingly less accommodating regional and global context.
  - China will maintain average growth in the 6%-7.5% range, underpinned by gradual economic rebalancing and continued efforts to manage risks in the financial system.

How about **inflation?** Here, we were quite evenly balanced with somewhat of a tilt toward the possibility of higher and less stable global inflation over the three-to-five year horizon. It remains a delicate balance, however, between two competing groups: (i) supply shock vulnerability, lower growth potential, currency debase, etc. versus (ii) output gaps, limited price pass-throughs, deleveraging, fiscal contraction, etc.

**Investment implications**

Translating all this into medium-term guardrails for portfolios requires an assessment of initial market pricing (currently assisted by central banks) and initial positioning (yes, many of our clients have benefited from the central bank wave, with over 90% of PIMCO’s assets under management outperforming (net of performance fees as of 31 March 2013) their benchmarks for the 5-year period).³ With these two qualifications, here is what we concluded:

**Do not lose sight of the extent to which asset prices have been disconnected from fundamentals and, thus, require major eventual validation by fundamentals.** Especially with ever-elevated prices, and absent a favorable growth shift, we will continue to bring down risk postures of portfolios, starting with the most exposed parts of the economic and financial capital structure, whether corporate or sovereign.

**Look more intensely for opportunities away from the central bank wave.** We believe that there are quite a few, judging from the work of our talented analysts and bottom-up

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³ Assets reflect those managed on behalf of third-party clients and exclude affiliated assets.
resources located around the world. And their portfolio impact increases notably with today’s “winner takes all” and “killer app” tendencies. So, look for continued, selective offense to accompany our increasingly defensive general positioning over time.

Resist the short-term focus of those financial pundits who have abandoned fundamentals in favor of just obsessing with what is cheaper only in relative terms. As an illustration in fixed income space, consider the absolute level of yields on highly risky sub-investment-grade bonds and ask yourself whether they bear any relation to the risk being underwritten. Yet some pundits are pushing them only on the basis that they are cheaper than investment grade bonds.

Recognize the risk of falling hostage to outdated and backward-looking labels, benchmarks, guidelines and mindsets. As hard as this is, conventional wisdom, concepts and practices need to evolve to better navigate different realities.

Do not give up liquidity cheaply. Optionality is valuable in a changing world subject to unpredictable forces. And does anybody really doubt that European banks will soon be forced to dispose of good assets as they finally go through a proper stress test and need to both raise capital and realign their balance sheets?

Be careful of longs in currencies of hyperactive central banks that do not enjoy reserve currency status. And remember, the lineup of central bank activism will evolve quite a bit over the next few years.

Protect against haircuts. You should expect future sovereign and corporate rescues to involve a growing set of bail-ins. Whether you call them haircuts or the more politically correct “PSI” (private sector involvement), a larger part of the capital structure is now vulnerable to capital losses.

Evolve risk management approaches. Correlations have and will continue to change in this fluid world heavily impacted by central banks. Diversification, while necessary, is no longer sufficient for portfolio risk mitigation. Tail hedging can be an important addition, which also speaks to a broader issue: Narrow product mindsets need to continue to evolve into more holistic solution approaches.

Finally, recognize that consensus return expectations may adjust down from here. The whole point of all this unusual central bank activism is to bring to today future growth and future returns – hopefully to put economies and markets on a better long-term trajectory but also exposing them to the risk of severe air pockets should growth disappoint. You should expect alpha, rather than the asset class betas, to constitute a larger share of expected returns.

Concluding remarks
Back in 2006, PIMCO rejected the consensus view of a “great moderation” (and “goldilocks”) in favor of the concept of a “stable disequilibrium.” Specifically, we argued that stability on the surface was accompanied by weakening and increasingly unstable underpinnings.

Our concept of a stable disequilibrium is back. Whether it is due to a lack of timely understanding, an insufficiently agile political system or imperfect policy tools, the collective response to the unusual multi-speed dynamics of the last few years has added this concept to the dynamic characterization of the New Normal.

There are also consequential T-junctions out there somewhere, with some economies, segments and markets ending up following one of two highly contrasting paths. Their exact timing is difficult to specify given the myriad of economic, financial, institutional, political and social factors in play.

And then there are hyperactive central banks, the markets’ best friends in recent years. By all means, respect and benefit from the massive wave they have created and will continue to bolster. But also be mindful. It is already a very crowded wave and just small tweaks to accompanying “conventional wisdoms” can lead to major price adjustments (recall what has happened to gold in the last few weeks).

In looking where and how to position portfolios, long-term investors should realize that, in addition to balance sheet strength, the resumption of acceptable and sustainable levels of real economic growth is critical – both in a positive sense, to generate sufficient capital gains and income, and in a negative sense, to avoid the increasing likelihood of haircuts that will become more creative and unpredictable.
We will do our best to reflect all this in positioning the savings, pensions, investments and retirement funds you have entrusted to us to manage. We will be emphasizing the importance of economic growth, and work very hard to sidestep haircuts. And we will seek to navigate this environment for you by maintaining a higher degree of operational agility and a solid dose of resilience.

Thank you again. Bill, our colleagues and I greatly appreciate your trust in PIMCO.

Mohamed A. El-Erian

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1 See “PIMCO’s Secular Forum Preview,” PIMCO, January 2013.
2 Additional information may be found in “Secular Outlook: Navigating the Multi-Speed World,” PIMCO, May 2011, and “Secular Outlook: A New Normal,” PIMCO, May 2009.
4 In doing so, we recalled Tom Friedman’s elegant differentiation between an interconnected world and an interdependent one. In the latter, you can become dependent on your competitors (as in the importance for the U.S. of China avoiding a hard landing) and your friends can bring you down (as in the risk that another European crisis derails America’s healing process). See “The World We’re Actually Living In,” The New York Times, 29 September 2012, http://www.nytimes.com/2012/09/30/opinion/sunday/friedman-the-world-were-actually-living-in.html?_r=0

A word about risk:
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