

SECULAR OUTLOOK • MAY 2014

The New Neutral

SECULAR OUTLOOK

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INVESTMENT IMPLICATIONS

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“May you live in interesting times,” said Robert Kennedy in 1966, and PIMCO’s just-completed 2014 Secular Forum certainly took place in interesting times. Maybe too interesting! Drawing on superb presentations from six outstanding invited speakers and from our class of new MBAs and PhDs, as well as the robust/focused internal discussion that followed these presentations, PIMCO investment professionals reviewed the landscape of the global economy, financial markets, central banking, and geopolitical hotspots with three goals in mind: to develop a concept, a construct and a compass that the firm can use to navigate global markets over our secular horizon of three to five years. That concept, that construct, and that compass all led us to what we call PIMCO’s New Neutral, a phrase that suggests exceedingly low real policy rates for our secular timeframe. Much about that later.



PIMCO 2014 SECULAR FORUM SPEAKERS

Six experts presented their latest insights at the Forum, bringing fresh perspectives to challenge our internal expertise.

Robert Arnott

Founder, Chairman and CEO of Research Affiliates, LLC
Demography and markets

Dr. Michael Greenstone

3M Professor of Environmental Economics in the Department of Economics at the Massachusetts Institute of Technology
Climate change, its impacts, and potential policy responses

Dr. Carmen M. Reinhart

The Minos A. Zombanakis Professor of the International Financial System at Harvard Kennedy School. Co-Author (with Kenneth S. Rogoff) of *This Time Is Different: Eight Centuries of Financial Folly*
The global financial crisis and its long aftermath

Nate Silver

Founder, FiveThirtyEight.com. Author, *The Signal and the Noise*
The problems of big data and suggested solutions

Dr. Anne-Marie Slaughter

President and CEO of the New America Foundation. Bert G. Kerstetter '66 University Professor Emerita of Politics and International Affairs at Princeton University
Geopolitical hot spots and blind spots

Sir Paul Tucker

Deputy Governor of the Bank of England, 2009–2013. Senior Fellow at Harvard Kennedy School and Harvard Business School. Visiting Fellow of Nuffield College, Oxford
The international monetary system

We arrived early Monday morning on 5 May realizing that we needed to answer several big questions to get our secular call right:

- Will the post-crisis headwinds of deleveraging, deglobalization and reregulation abate? How will extant debt overhangs impinge on growth and constrain policy?
- When and where will monetary policy normalization commence and will it proceed smoothly? What are the benefits, costs and risks? What are the constraints on policy placed by an evident overhang of leverage?
- Is a multi-speed world sustainable over our secular horizon? If so, to what trend growth rates are the major economies converging?

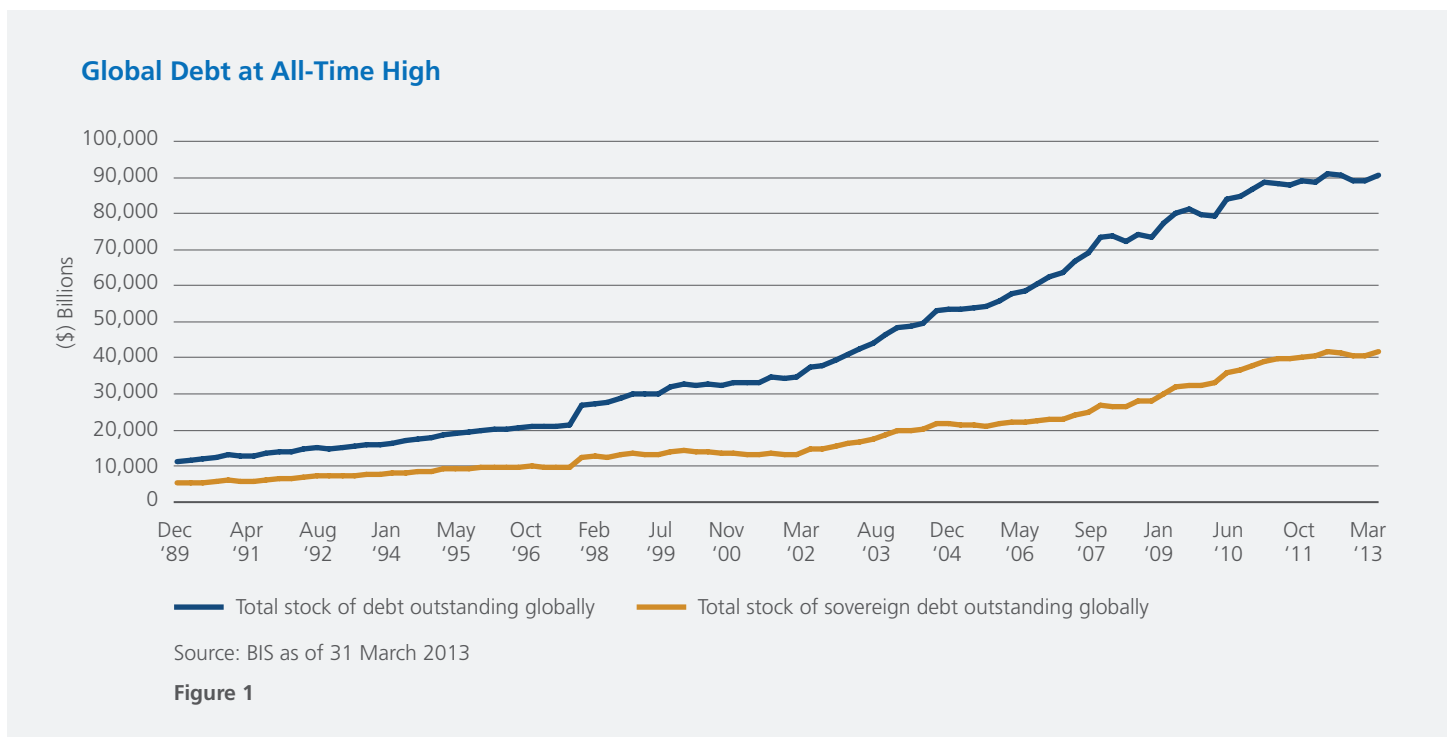
To answer these questions, we began by identifying a set of initial conditions upon which to base our secular outlook and our answers to these crucial questions. The key initial conditions we focused on include:

- An absence to date of aggregate deleveraging in the global economy, in the face of...
- A sharp increase in leverage in China funneled through a vast, complex and fragile shadow banking system
- A global economy whose growth model has thus far been unable to generate global aggregate demand in line with global potential output even with the fix of hyperactive post-crisis policies (the 2009–2014 model)
- A pronounced slowdown in not only the growth but the growth prospects of the key emerging economies
- A pronounced slowdown in the contribution of international trade to global growth and the imposition of capital controls by many emerging economies in the name of macroprudential policy
- A reregulation of the international financial system

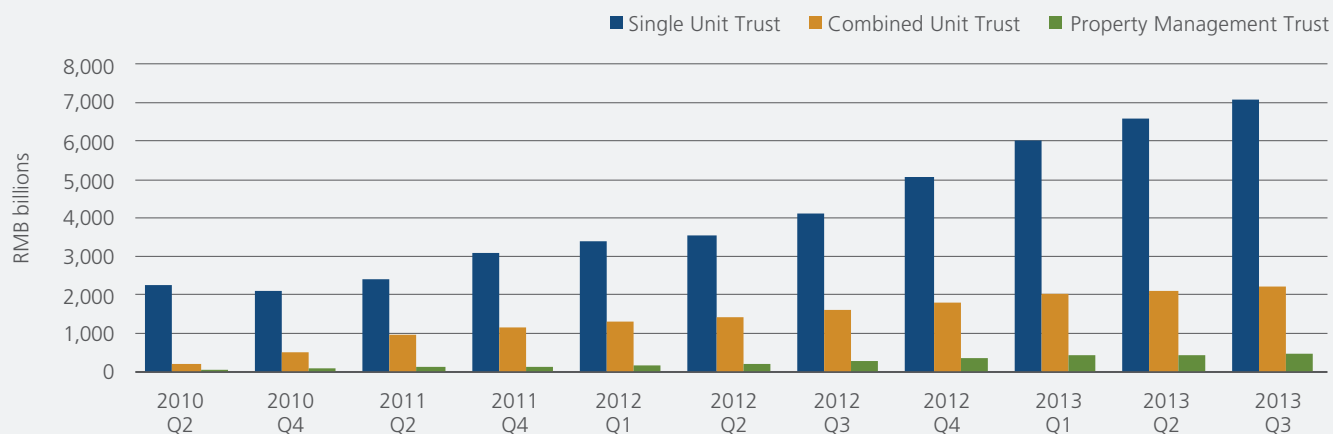
A leverage overhang will constrain policy normalization

As can be seen in Figure 1, the total stock of public and private debt outstanding in the global economy is at an all-time high in dollar terms (and as a share of global GDP is larger today than it was in 2007, before the crisis). So while there is a consensus that an excess of private sector and European sovereign leverage contributed to the global financial crisis – and later the European sovereign crisis – there has been no decline globally in aggregate leverage. Private sector deleveraging that has occurred has, at least on a global basis, been replaced by public sector leverage.

And then there is China! The existence of a shadow banking system in China is by now well-known, but only recently has the scale, scope, complexity and fragility of that system become apparent. As shown in Figure 2, by accepted estimates the amount of leverage in China’s shadow banking system has quadrupled in the past four years and now exceeds 10 trillion RMB (about 1.6 trillion U.S. dollars). The view of the PIMCO Asia Pacific Portfolio Committee, supported by excellent analysis from our entering class of MBAs, is that policymakers in China will likely attempt to limit shadow banking over the next three to five years. While China clearly has the will and – with over 4 trillion dollars in foreign exchange reserves – the wallet to do so, the process, even if successful, is likely to be a headwind – perhaps a material headwind – for China GDP growth over our



China Shadows Get Longer



China shadow banking vehicles (RMB billions)

Source: CLSA as of 30 September 2013

Figure 2

secular horizon. Indeed, our consensus view is that it will be very difficult for China to grow at the about 7.5% rate that President Xi and Premier Li are aiming for. We think 6.0-6.5% is the better number over the next few years. Moreover, we agreed that China's current plans for a gradual liberalization of its internal interest rate market and its external capital account will depend crucially on how the limits to shadow banking proceed. **Chinese officials are well aware of the disasters that have befallen countries that liberalized their external capital accounts before cleaning up their banking systems, and as a result monetary policy must remain accommodative.**

In Europe, the transformation in the sovereign debt market since Mario Draghi's "whatever it takes" promise in July 2012 has been remarkable. Ireland, which just exited an IMF bailout program in December, can now issue 5-year debt at yields well below 5-year Treasuries. Europe is now growing, but our expectations for eurozone growth rates over the next three to five years start with a 1% handle and are not likely to average more than the post-crisis potential growth rate of about 1.25%. So while Europe may be "boring" over our secular horizon, it is not really healthy, as a number of Forum participants pointed out. The stock of sovereign debt in many countries is too large relative to GDP to be sustained unless interest rates remain very low or growth rebounds to well above our baseline view. **And so in Europe the leverage overhang is likely to remain an important consideration for ECB policymakers in the years to come, keeping rates lower for longer and adding to the odds of a major quantitative easing program.**

In the U.S., the private sector has deleveraged and U.S. household as well as corporate balance sheets are in much better shape than they were before the crisis. Looking forward, the prospects for U.S. growth over the next three to five years encompass a wider range of optimistic outcomes than do prospects for growth in the other major economies. There are very real prospects for the energy revolution to transform the U.S. economy and boost growth, employment and competitiveness, and these could in fact materialize during our secular horizon. However, the Congressional Budget Office and the Fed have marked down their estimates of potential growth for the U.S. economy over the next three to five years, coming closer to the core thesis of PIMCO's 2009 New Normal hypothesis. There is a risk that the *global economy* – not just the U.S. – will be unable to grow and generate inflation at pre-crisis levels for many years to come – *even if monetary policy rates remain at zero in nominal terms and negative in real terms. Thus the theme of our Secular Outlook is "The New Neutral."* If real neutral policy rates are centered at 0.0% or less for the next three to five years the investment implications are significant because the level of short term rates forms a fundamental component of all asset prices. Bill Gross will elaborate in the Investment Implications.

A multi-speed world of countries converging to modest potential growth rates

Over the past 15 years, the global economy has operated under two different growth models. Between 1999 and 2007, the growth model operated through ever larger trade imbalances between emerging market and commodity exporting countries – who ran larger and larger surpluses – and a group of rich countries – first and foremost the U.S. – who ran larger and larger trade deficits. Global imbalances were then seen as a problem by some, but they were really a symptom of the global geographic distribution of aggregate supply and demand, with excess supply in the high-saving emerging market countries and excess demand in some low-saving rich countries (and with energy exporting countries doing quite well as they exported to both). These supply-demand and saving-investment imbalances generated huge international capital flows that were sufficient to bring global demand into line with abundant global supply of goods at something approximating the full employment of global resources.

That growth model obviously broke down in the global financial crisis years of 2007–2009 as global imbalances shrunk in line with global aggregate demand. From 2009–2014, the global economy has operated under stimulus from “nontraditional” monetary policies that pushed policy rates to zero and ballooned central bank balance sheets through massive “chunks” of quantitative easing. Also, the global policymakers “went Keynesian” for a couple of years during and following the crisis by delivering a large dose of fiscal stimulus. The good news is that, as a result, the global economy avoided depression and deflation. But that’s all they did or could reasonably do. **The reality is that now, five years after the global financial crisis, average growth in the global economy is modest and the level of global GDP remains below potential. The global economy has not as of today found a growth model that can generate and distribute global aggregate demand sufficient to absorb bountiful global aggregate supply. Unless and until it does, we will be operating in a multi-speed world with countries converging to historically modest trend rates of potential growth with low inflation. 0% neutral real policy rates for many developed and some developing countries will likely be the investment outcome.**





Investment implications: “the New Neutral”

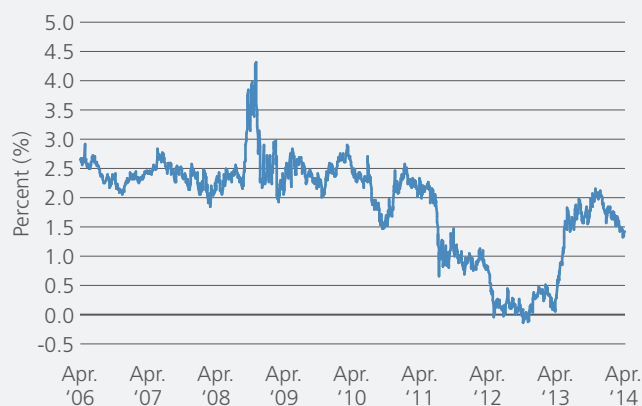
The implications of a multi-speed world of global economies converging to slower yet **increasingly stable** growth rates and low inflation have likely been substantially reflected in current asset prices. Credit spreads globally, for instance, are narrow as a reflection of low and declining rates of defaults. And too, stock prices are approaching peaks in some countries because of stable profit margin expectations even in the face of PIMCO’s New Normal slow growth thesis advanced five years ago. Emerging market equities have underperformed because of slower perceived future growth rates, yet risk assets in general have delivered excellent returns based significantly on quantitative easing and associated credit creating policies that have elevated asset prices artificially. But investors wonder what’s left in the tank. With yields so low, spreads so tight, and Shiller P/E ratios above historical norms there appears to be more risk than reward on the horizon. PIMCO would agree that the rewards over the next 3-5 years will be exceptionally low when compared to historical norms. Financial repression as it continues for years to come will almost ensure that outcome. The risk, however, may be lower than normal if PIMCO’s “New Neutral” plays out. There may be lemonade to be made from those low returning lemons.

While we would admit that PIMCO, policymakers and investment managers worldwide are uncertain as to what neutral policy rates in the U.S. and other economies should be, we are confident that asset markets have gone too far in believing that central banks can even approach policy rates that seemed “neutral” for decades prior to Lehman in 2008. In the U.S. for instance, real policy rates of 1-2% and nominal policy rates of 3-4% before the end of the decade are currently priced into the markets as shown in Figure 3. Logic and history would suggest otherwise. PIMCO internal research^{1,2} as well as historical statistics over the past century suggest “neutral” is much closer to 0% real (especially during periods of high leverage and low growth) than the 1-2%

currently anticipated by asset markets. Before Paul Volcker broke the back of inflation beginning in 1979, real policy rates averaged .5% in the U.S., 0% in the U.K. and negative for Japan and much of Euroland for the first 80 years of the 20th century.

TOO High for Neutral

Market priced real U.S. 5-year yields 5 years in the future. Recently at 1.4% (PIMCO expects lower)



Source: Bloomberg as of 12 May 2014

Figure 3

If the future resembles those neutral policy rates, then the investment implications are striking: low returns yet less downside risk than investors currently expect; an end to bull markets as we’ve known them, but no perceptible growling from the bears. The reason is that New Neutral global policy rates lower than **currently priced into asset markets allow for a margin of safety that reduces downside risk and minimize bubbles.** The New Neutral is not an explicit Yellen or Draghi *Put* but it can be a rather comforting pacifier, suggesting that yields, credit spreads and P/E ratios themselves are more rational than many market observers fear.

Still, many investors may be disappointed with this rather weak brew of lemonade. Zero percent neutral policy rates imply similarly low returns on risk assets, perhaps 3% for bonds and 5% for stocks over our secular timeframe, and 3-5% expected asset returns cannot satisfy many liability structures dependent on more. How can PIMCO help? First of all, we plan to continue to utilize our globally recognized and frequently awarded “bottom-up” credit and equity analysis to pick winners and avoid losers in asset markets. Mark Kiesel, Christian Stracke and a team of hundreds scan the globe daily for ideas to generate alpha, even given a New Normal, New Neutral future. Similarly, alternative asset, asset allocation, solutions and risk analytics teams are at your service. While alpha, information and Sharpe ratios will be lower than in prior years, we hope to be close to the top of the performance list, as has been our destination during much of our 40-year history.

Secondly, if investors require a stronger glass of lemonade with higher returns, PIMCO recognizes that the New Neutral may allow for the assumption of greater carry portfolios in order to attain them. **A sow’s ear can be turned into a silk purse even if 10-year Treasuries are range-bound between 2½% and 4% as we expect over our secular horizon.** If cash and policy rates are low yielding but relatively stable, then cash can likewise be a cheap liability. It can be borrowed by investors to enhance returns or swapped by corporations to reduce their interest rate expenses. Structured products such as Unconstrained Bond, hedge, and alternative asset strategies offered by PIMCO can increase the possibility of exceeding the low returns produced by the New Neutral. Total Return portfolios can do the same thing in more moderate measures. Don’t give up on actively managed bonds which can utilize lower asset price volatility to exceed New Neutral yielding indices!

The key for PIMCO and our clients over the next 3-5 years will be to recognize this New Neutral before the market does – just like we did in 2009 with our New Normal. We intend as well to search the global marketplace with its multi-speed economies, finding the cheap assets from a bottom-up perspective and concentrating them in countries and asset markets where the New Neutral has been bearishly overlooked.

As we close this 2014 *Secular Outlook* we want to emphasize that we remain the PIMCO you have always known: client focused, secularly directed, innovative and first mover oriented, as well as bottom-up alpha targeting. It’s been a great formula during secular bear, bull and now New Neutral markets going forward. We treasure your confidence in us and will strive to return it with higher returns and lower risk than the competition.

KEY TAKEAWAYS

From our Outlook...

- We are operating in a multi-speed world, but over a secular horizon this state is likely to converge to a New Neutral of historically modest trend growth.
- Total global debt outstanding remains at peak levels around the globe, and this combined with subpar growth will constrain central bankers and future policy rates.
- The prospects for U.S. growth over the next three to five years encompass a wider range of optimistic outcomes than do prospects for other major economies, though growth at pre-crisis trends is unlikely for years to come.

From our Investment Implications...

- Most asset prices now reflect the convergence to slower yet increasingly stable growth rates.
- But in the U.S., the bond market is pricing in real policy rates of 1-2% and nominal rates of 3-4% before the end of the decade. We view the neutral rate as likely to be much closer to 0% real and 2% nominal in the years ahead. Similar conditions exist in major global economies.
- At first glance there appears to be more risk than reward on the horizon. However, if the New Neutral plays out, the bubble risk may be lower than expected, while asset returns are likely to be subdued, in the 3-5% range.
- We plan to continue to utilize our frequently awarded bottom-up credit and equity analysis to pick winners and avoid losers in asset markets.
- We believe the New Neutral allows for the assumption of higher than normal carry portfolios to potentially realize returns. Our Unconstrained Bond, hedge and alternative asset strategies can allow for the potential to exceed low returns as can Total Return portfolios in more moderate measures.

¹ See "Investment Outlook: Achoo!" PIMCO, May 2014.

² See "Asset Allocation Focus: Forecasting Bond Returns in the New Normal" PIMCO, March 2013.

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