PIMCO

CYCLICAL OUTLOOK

March 2016

Calmer C's Ahead?

China
Commodities
Central Banks

DOMINATE THE GLOBAL OUTLOOK

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Navigating an environment of tepid nominal growth and near-zero or negative interest rates was never going to be easy. Still, the events that have unfolded since the Federal Reserve's first rate hike in almost 10 years last December easily surpassed the imagination of most central bankers, observers and investors alike.

And so there was much to talk about when PIMCO's investment professionals gathered at our Newport Beach office in early March for our quarterly Cyclical Forum to deliberate and update our economic and market outlook for the next six to 12 months. In addition to hearing from PIMCO's regional portfolio committees from around the globe, we were fortunate to benefit from the perspective of PIMCO's newly created Global Advisory Board, consisting of its chair Ben Bernanke, Gordon Brown, Anne-Marie Slaughter, Ng Kok Song and Jean-Claude Trichet, which held its inaugural meeting on the day before our forum.

Much has occurred since our December 2015 forum. Investors seemed underwhelmed with the Fed's first rate hike, which had been well-telegraphed, but China's leadership allowing faster currency depreciation in the first few days of this year – which may in part have been a reaction to the Fed rate hike – sparked another major risk-off move in financial markets resulting in a considerable tightening of global financial conditions. We are all familiar with the rest of the story: Oil plummeted to new lows, the Bank of Japan (BOJ) surprised markets by taking its interest rate on excess reserves negative for the first time ever, and a further massive sell-off in bank equity and debt, and in risk assets more broadly, ensued. The European Central Bank's (ECB) suggestion that it would cut rates further into negative territory contributed to European banking sector underperformance. This sent a strong signal that markets were losing faith in central banks' ability to further prop up asset prices, growth and inflation, as they had been doing over and over again since the 2008 financial crisis.

LOWERING OUR SIGHTS ON GLOBAL GROWTH AND THE FED

Equity markets, credit indexes and oil prices have rebounded from their mid-February lows, helped by more stable daily fixings of the Chinese yuan (CNY), expectations of a slower-moving Fed and signs that the ECB and the BOJ may have had second thoughts on the relative merits of negative rates after discovering their dark sides. But notwithstanding the recent calmer tone in markets, we concluded at our investment forum that the weaker global economic momentum at the end of 2015/start of 2016 and the significant, though temporary, tightening in global financial conditions in January/February meant that 2016 economic growth and inflation would likely come in at or below the ranges we had forecast in December for most major economies.

The general sense at our forum was that while the almost seven-year-old "BBB economic expansion" has been underwhelming all along, this year it would likely feel even more BBB: bumpy, below-par and brittle. And so we lowered our forecast for calendar year 2016 global real GDP growth by a quarter-point to a range of 2% to 2.5%. Actual global GDP growth was 2.8% in 2014 and 2.6% last year; our forecast sees the slowdown continuing. Moreover, with central banks discovering the limits of monetary policy divergence, which became apparent in the form of excessive U.S. dollar strength, and U.S. monetary policy to some extent being "made in China" given the negative impact of CNY depreciation on financial conditions, we concluded that the Fed would likely only hike rates once or twice this year. In fact, at the Federal Open Market Committee (FOMC) meeting in March, which took place after our Forum, the median FOMC participants' forecast came down from the four hikes by the end of 2016 (as projected in December) to two hikes in 2016, and thus is much closer to our forecast. And, in line with our analysis, the Fed cited global developments as a major risk to the U.S. outlook.

MORE HEADWINDS FOR THE MULTI-SPEED GLOBAL ECONOMY

Beneath the surface of slow overall global growth, this is still a multi-speed, multi-faceted global economy. Economic and policy divergence will continue to create a plethora of tensions, volatility, risks and opportunities. However, wherever one looks around the globe, nominal and real GDP growth and, therefore, interest rates are likely to stay well below historical norms, very much in line with our time-tested secular New Normal concept of a world economy transformed after the global financial crisis of 2008. The New Normal is characterized by both weak potential output and a lack of aggregate demand, reflecting high debt levels and an excess of global desired saving over investment – the global savings glut. This continues to provide significant headwinds for growth not only on our secular (three- to five-year) horizon but also over the cyclical (six- to 12-month) timeframe. It underpins our expectations for low "neutral" central bank policy rates – along with The New Normal, we have described The New Neutral, referring more explicitly to central bank policies converging to lower neutral rates than in previous economic cycles.

Complicating things are the additional headwinds emanating from rising political uncertainty in multiple constituencies: the U.S. presidential election, rising populism in Europe, the refugee crisis, Brexit risk in the UK and unstable governments in Brazil and beyond. While political risks are difficult to quantify, they have the potential to dent consumer confidence and corporate animal spirits further, and their impact may be non-linear especially when desired saving is high and desired investment is low for other, more secular reasons. One very seasoned observer even suggested that "zombie governments" around the world were the main reason why the global economy is in the doldrums.

THE GOOD NEWS? NO RECESSION!

However, after weighing all the factors, we decided that this is not the time to despair. Despite the multiple headwinds to the BBB, multi-speed global expansion, we agreed that the risk of a U.S./global recession on our cyclical six- to 12-month horizon remains relatively low, and certainly lower than equity and credit markets had come to price in during the first couple of months of 2016. Both our forecasting models and our forum deliberations suggest a recession probability of at most 20%. While the economic expansion is aging, it is important to remember that expansions don't die of old age – they are usually ended by a combination of serious imbalances and significant central bank tightening. Right now, none of the typical signals of imminent collapse are flashing: no over-consumption, no over-investment, no over-heating, and no monetary overkill. In short, we expect this expansion to last (for more detail, please see our *Macro Perspectives*, "The Recession of 2020").

The three "C's"

However, in an uncertain world with plenty of potential economic, financial and political tail risks, we will not focus only on a particular baseline forecast. Rather, it pays for investors to explore the risks around the baseline, thinking hard about the distribution of probabilities over a range of conceivable outcomes.

To that end, we concluded that there are three main swing factors for the global economic and financial market outlook this year: China, commodities and central bank policies. Depending on different paths for each of these "three C's," it is easy to imagine different shades of darker or brighter economic and market outcomes this year than in our baseline scenario. And given that we cannot know for sure which scenario(s) will come to pass, it makes sense to take a very careful approach in portfolio construction.

China

Watch capital outflows and the CNY

Forum participants viewed a big, disruptive CNY devaluation as by far the single biggest risk for the global economy and markets this year.

To be sure, our base case is for a more benign muddling-through, where the CNY depreciates gradually and mostly orderly (our Asia-Pacific Portfolio Committee expects a 7% CNY depreciation versus the USD [U.S. dollar] over the next year), supported by continued currency intervention and more targeted capital controls. Also, a broadly stable USD versus the euro and the Japanese yen should make life a little easier for the People's Bank of China as this would mean relative stability of the CNY against a basket of foreign currencies, as opposed to the relentless appreciation pressures jointly with the USD against the rest of the world over the past two years.

The key uncertainty, however, is the size of the capital outflows by Chinese companies and households this year:

- One very experienced China watcher told us at the forum that the bulk of the outflows was due to companies covering their USD liabilities and should thus subside fairly soon as most of the hedging seems to have been done.
- A less benign view proposed by other participants states that Chinese investors, having been forced to invest mostly in domestic assets in the past, are eager to internationally diversify their portfolios now that capital account liberalization has started. If so, capital outflows would have only just begun and even the more than $3 trillion of Chinese foreign exchange reserves could be depleted relatively soon.

Commodities

The worst for oil could be over

Rightly or wrongly, financial markets have viewed the drop in oil prices earlier this year as a clear negative, mainly because it raises the risk of defaults in the U.S. and global energy complex, which in turn could lead to contagion to bank balance sheets. Conversely, the recent recovery in prices has led to a big collective sigh of relief in equity and credit markets. Our commodity team presented a constructive baseline view where higher demand sparked by lower prices and, more importantly, ongoing supply rebalancing will likely take oil higher in the course of this year to around $50 (that said, we are cognizant of the risk of a renewed drop below $30 in the near term).

Central banks

Testing the limits of policy potency

Our biggest debates at our forum raged around the question of whether central banks still have the *ability* to stimulate asset prices and the economy or whether the toolkit is now exhausted. To be clear, hardly anybody doubts their *resolve* to do whatever it takes in the face of persistent headwinds to growth and inflation. However, there is a growing skepticism among market participants and here at PIMCO about whether additional quantitative easing (QE) is still effective given how low bond yields already are, and even more so about the negative side effects of negative interest rates on bank profitability and thus the crucial bank lending channel. Overall, we believe that monetary easing, if done in the right way, can still be supportive of asset prices, growth and inflation, even though the returns are clearly diminishing.

Somewhat encouragingly, judged by the ECB's easing package announced shortly after our forum, central banks appear to have begun harboring the same kind of doubts about the efficacy of negative interest rates and are now adjusting their toolkit yet again. The ECB added a larger credit easing component to QE through additional purchases of non-financial corporate bonds and decided to provide more multi-year funding to banks at potentially negative interest rates, which has the opposite effect on bank profitability of negative deposit rates. Also, the BOJ refrained from cutting the interest rate on excess reserves further into negative territory at its 15 March policy meeting and left the door open for additional purchases of private sector assets such as exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) at a later stage. And, even though this was only a remote possibility for the Fed anyway, Fed Chair Janet Yellen emphasized in her 16 March press conference that a negative interest rate policy was "not something that we are actively considering."

So while China, commodities and central bank policies could potentially cause significant downside risks to economies and risk assets and will likely continue to be sources of volatility this year, our base case for the cyclical outlook remains cautiously optimistic: China is more likely than not to manage the challenges of capital outflows without a major disruptive devaluation, oil prices look more likely to rise than fall, and central banks seem able and willing to find the right tools to support asset prices and keep the BBB economic expansion on track.

ABOUT OUR FORUMS

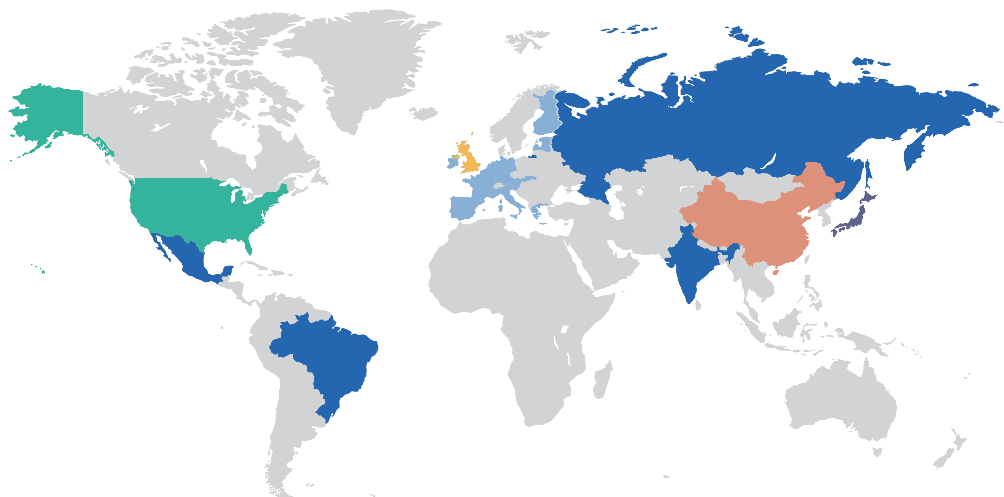
PIMCO's investment process is anchored by our Secular and Cyclical Economic Forums. Four times a year, our investment professionals from around the world gather in Newport Beach to discuss and debate the state of the global markets and economy and identify the trends that we believe will have important investment implications. We believe a disciplined focus on long-term fundamentals provides an important macroeconomic backdrop against which we can identify opportunities and risks and implement long-term investment strategies. At the Secular Forum, held annually, we focus on the outlook for the next three to five years, allowing us to position portfolios to benefit from structural changes and trends in the global economy. At the Cyclical Forum, held three times a year, we focus on the outlook for the next six to 12 months, analyzing business cycle dynamics across major developed and emerging market economies with an eye toward identifying potential changes in monetary and fiscal policies, market risk premiums and relative valuations that drive portfolio positioning.

GROWTH OUTLOOK FOR 2016 (GDP RANGE)

United States
1.75% to 2.25%

United Kingdom
1.5% to 2.0%

China
5.5% to 6.5%



BRIM
0.75% to 1.25%

BRIM is Brazil, Russia, India, Mexico

Eurozone
1.0% to 1.5%

Japan
0.25% to 0.75%

FORECAST	REAL GDP		HEADLINE CPI INFLATION	
	2015[1]	2016 FORECAST	2015[1]	2016 FORECAST
United States	2.4%	1.75% to 2.25%	0.1%	1.0% to 1.5%
Eurozone	1.6%	1.0% to 1.5%	0.0%	0.0% to 0.5%
United Kingdom	2.2%	1.5% to 2.0%	0.0%	0.5% to 1.0%
Japan	0.5%	0.25% to 0.75%	0.8%	0.25% to 0.75%
China	6.9%	5.5% to 6.5%	1.4%	1.0% to 1.5%
BRIM[2]	0.4%	0.75% to 1.25%	8.6%	6.5% to 7.5%
World[3]	**2.6%**	**2.0% to 2.5%**	**1.5%**	**1.5% to 2.0%**

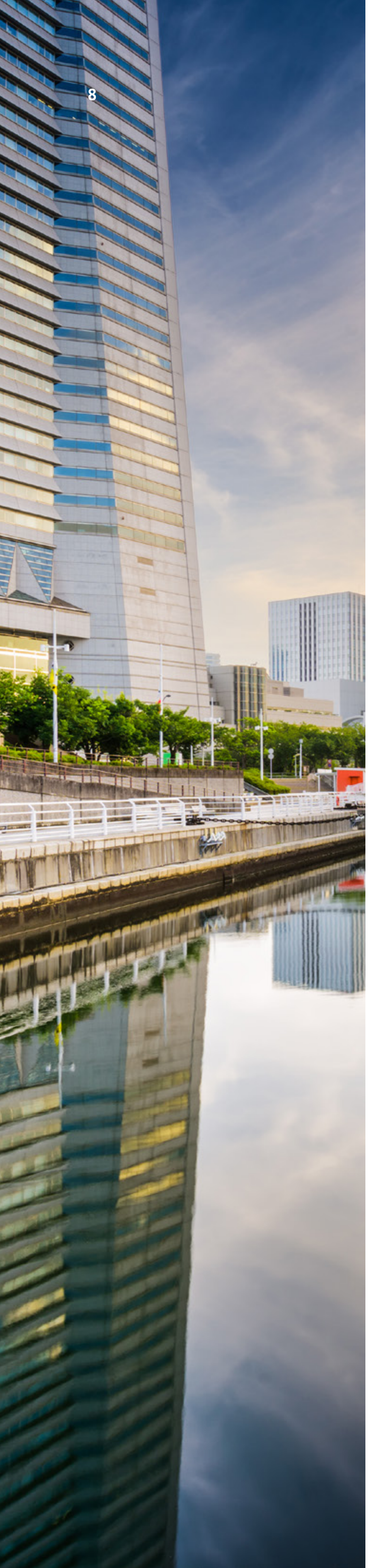
[1] 2015 data for real GDP and inflation represent calendar year averages
[2] BRIM is Brazil, Russia, India, Mexico
[3] World is the GDP-weighted average of countries listed in table above
Source: Bloomberg, PIMCO calculations. Note: Forecast for 2016 is as of March 2016 Cyclical Forum.

U.S. economy: Zeroing in on two percent

In a world of deficient aggregate demand and heightened uncertainty, the U.S. remains the "best of a bad bunch" in terms of economic growth. We continue to see a two-speed economy with robust consumer spending and residential investment on the one hand, and weak export growth and capex on the other. The net result is unexciting, slightly above-trend economic growth in a 1.75%–2.25% range for calendar year 2016. This is consistent with a further erosion of labor market slack and a gradual acceleration in wages. Thus, we expect the "delicate handoff" from slowing job growth (as the labor market reaches full employment) to higher wages as the main driver of income creation to succeed, supporting further decent gains in consumer spending. Assuming a gradual lift in crude oil prices to $50 per barrel by year-end, headline inflation (as measured by the Consumer Price Index or CPI) is likely to hover sideways in a 1.0% to 1.5% range for much of the year, before rising to 2% by the end of the year, thus converging with core inflation which is expected to trend broadly sideways at slightly above 2% throughout the year. With PCE inflation (personal consumption expenditures inflation, which is expected to run about 0.5% below CPI inflation) remaining below the Fed's 2% target for the fifth year in a row, and global developments still posing considerable risks to the outlook, we expect the Fed to move cautiously as mentioned, raising rates only once or twice this year, slightly more than the market is currently pricing in.

Eurozone and UK: OK growth, tricky politics

For the eurozone, our baseline for calendar year 2016 is for trend-like GDP growth in a below-consensus 1% to 1.5% range and a continued significant undershooting of the ECB's "below-but-close-to-2%" inflation objective, with headline HICP (Harmonised Index of Consumer Prices) inflation in a range of 0% to 0.5% and core inflation staying below 1%. We expect the headwinds for growth from weak global demand and the tightening of financial conditions earlier this year to be roughly offset by the lagged effects of the weaker euro on exports, low oil prices and rising employment supporting consumption, and fiscal policy turning slightly expansionary for the first time since 2009. The ECB's March easing package should also be mildly supportive, with higher purchases of public sector bonds and, for the first time, also non-financial corporate debt, as well as lower marginal lending and deposit rates, and long-term, large-scale loans to banks at potentially negative interest rates. Yet, with inflation likely to continue to undershoot the objective (on the ECB's and our own projections for at least another couple of years), further ECB easing later this year appears to be in the pipeline.



The UK outlook is complicated by the "Brexit" referendum on 23 June. We attach a 60% probability to a vote to stay in the European Union. In our baseline "stay" scenario, we see growth in a below-consensus 1.5%–2.0% range for 2016 due to the drag from net exports and further fiscal tightening amounting to about 1% of GDP. Bank of England Governor Mark Carney will likely have to continue to write letters to the Chancellor every month this year (a statutory requirement if inflation deviates from the 2% target by more than 1%), explaining why inflation remains below 1%. In this environment, rates will likely remain on hold. We view the risks to our growth forecast as skewed to the downside mainly because we attach a 40% probability to a pro-Brexit vote. This could lead to a major hit to business investment and confidence, and could reduce GDP growth by 1%–1.5% over the one-year period following the referendum.

Japan: Lackluster growth and inflation

Japan is yet another case where we expect below-consensus economic growth and inflation to undershoot the central bank's target. We see GDP growth in a 0.25%–0.75% range for calendar year 2016 (which is not bad for a country with a shrinking population), about the same growth rate as 2015. With China slowing and the benefits from past yen depreciation petering out, the external sector will continue to be a small drag for economic activity. However, easier fiscal policy ahead of the upper house election this summer will provide some offset. Inflation looks set to continue to fall short of the 2% target – our forecast is for headline inflation in a range of 0.25%–0.75% and (U.S.-style) core inflation staying below 1% throughout this year. Against this backdrop, we anticipate further easing measures by the BOJ in the course of this year. Following markets' and the public's negative reaction to the introduction of negative rates in January, we expect the BOJ to tread cautiously on this front (though a further small reduction still seems likely) and rather concentrate on additional asset purchases skewed towards equity ETFs and J-REITs, as well as additional improvements in the lending program for banks.

China: Challenging transition, all eyes on capital outflows

China's transition from "old" (as in industrial, state-owned and export-oriented) to "new" (as in service sector, private and consumption-oriented) growth drivers continues to sputter. We expect "official" GDP growth to fall short of the government's 6.5%–7% target range this year, for three reasons. First, the room for monetary policy easing is limited as large liquidity injections and rate cuts would intensify capital outflows and therefore the downward pressure on the currency. Second, given the past buildup in public sector debt (mainly by local authorities and state-owned enterprises), the government seems unwilling to expand fiscal policy beyond the announced 3% deficit target. And third, volatility in the equity market and overcapacity in the property market have increased uncertainty and are weighing down on consumer confidence. This has also contributed to the capital outflows and the related downward pressure on the CNY. As discussed earlier, our baseline view is for gradual depreciation rather than a disruptive, large devaluation, aided by further currency intervention and measures to control capital outflows better.

Brazil, Russia, India and Mexico: Give us a catalyst

The economic outlook for BRIM remains disappointing overall: We forecast a slight pickup in GDP growth from 0.4% in 2015 to a range of 0.75%–1.25% for calendar year 2016, about in line with consensus. Yet, the small improvement is mainly due to Brazil's and Russia's economies contracting by less than last year while still being mired in recession. India is forecast to grow at a 7.3% pace this year, about the same as last year, while Mexico should see a small acceleration to 2.8% growth this year, slightly above consensus. In Brazil, the political situation remains fluid with many market participants suggesting that an impeachment followed by a change in government could provide a catalyst for reforms. In Russia, we think the sharp adjustment in unit labor costs presents an opportunity to rebalance the economy longer-term, and a further recovery in oil prices would help to end the recession. However, a V-shaped recovery looks unlikely to us. Finally, in Mexico, we are encouraged by the joint fiscal/monetary tightening announced in February, aimed at regaining investor confidence and stopping the depreciation of the currency.

Our baseline view on the CNY is for gradual depreciation rather than a disruptive, large devaluation, aided by further currency intervention and measures to control capital outflows better.

We see credit markets as offering value, and following recent dislocations we have a strong preference for higher-quality positions in the U.S., notably investment grade credit and senior financials.

INVESTMENT CONCLUSIONS

While we do not expect a recession in the U.S. or the global economy over the cyclical horizon, and think that financial markets have been over-anticipating recession risk, there are a number of key uncertainties and challenges that call for conservative portfolio positioning. Market valuations in general look fair to full, in our New Normal/New Neutral framework, but there are still pockets of value following the recent bout of market volatility. Valuations should be underpinned by central banks, but at the same time there are valid questions about the declining effectiveness of their interventions.

At a minimum, central banks have shifted from being purely suppressors of volatility to being contributors to volatility. In recent days they have contributed to a more positive tone in markets, but this was in response to their own friendly fire in Japan, Europe and beyond.

We continue to expect bouts of volatility, reflecting reduced market liquidity, some crowded positions and in turn a tendency for markets to overreact to relatively minor changes in fundamentals. Growing political risks across jurisdictions reinforce an outlook in which historical correlations and relations will be challenged.

We continue to see global policy divergence, with the Fed continuing its slow tightening cycle, while the ECB, BOJ and numerous other central banks continue to ease. But part of the uncertainty over the Fed outlook relates to the influence of global macro/financial conditions on its tightening path. The extent of policy divergence will be limited by the feedback to the U.S. economy via the U.S. dollar.

We see the currency war receding somewhat, with the recent G-20 statement, central bank rhetoric and actions suggesting that China will refrain from further sharp moves in its currency, a retreat from competitive currency devaluation efforts via negative deposit rates on the part of the BOJ and the ECB and instead a preference for QE and credit easing.

We see credit markets as offering value, and following recent dislocations we have a strong preference for higher-quality positions in the U.S., notably investment grade credit and senior financials. We continue to like non-agency mortgages based on a generally constructive view on the U.S. housing market outlook and think that favorable fundamentals help insulate the sector from near-term macro risks. Overall, in credit, we want to have perceived "safe" spread exposures that can weather storms, to be patient and long-term orientated in these investments, and to leave enough room to add to positions depending on our assessments of further credit market weakness.

We are broadly neutral on U.S. and global duration, expecting global rates to be broadly range-bound over the coming months. We are also broadly neutral on yield curve positioning; though we think that the level of rate hikes priced into the front end of the curve over the coming years is too low, there is a lot of uncertainty around the path. We continue to have a positive view on U.S. Treasury Inflation-Protected Securities (TIPS) based on our forecasts of modest reflation in the U.S. and attractive valuations.

In the eurozone, we see investment grade credit and European peripheral sovereign risk as broadly fair, but not cheap. Eurozone bank senior financial debt looks rich. There are select opportunities in subordinated debt but, at current valuations, we expect to focus on other countries with more predictable regulatory and legal frameworks including the U.S., Switzerland and the UK – Brexit risk notwithstanding.

Emerging markets face considerable challenges in a difficult macroeconomic environment and also given the spillovers from China, but we anticipate being able to find good opportunities – particularly so in an improving commodity market environment. After the recent recovery in commodity prices, we are broadly neutral on commodities in our asset allocation portfolios, with a preference for oil. We see credit markets as still offering better risk/reward potential than equities at current valuations. Within developed market equities, we think the cycle is more advanced in the U.S. and prefer Japan or Europe. We expect to see greater stability in emerging market equities in the event that commodities and the U.S. dollar behave in line with our base case expectations.

We expect to have less currency risk in our portfolios, reflecting the repricing of the U.S. dollar over the past two years, and the limits to global policy divergence, discussed above. We expect a gradual depreciation of the Chinese currency and the broader Asia currency basket and also see some attractive opportunities in commodity currencies.

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PIMCO

SECULAR OUTLOOK

June 2016

The Global Outlook: Stable But Not Secure

Good investment opportunities remain, but investors must be compensated for growing and heightened uncertainty and risks of policy exhaustion.

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How stable is the global economy, and what are the risks to that stability?

Critical questions like these drove vigorous debate when PIMCO's investment professionals gathered in May for our 35th annual Secular Forum. As always, our focus was to identify the key secular forces that will drive the global economy, monetary and fiscal policy, and financial markets over the next three to five years. To help us develop and refine our views, we heard from a stellar lineup of invited speakers, were briefed by our newest class of MBAs, and engaged with members of our Global Advisory Board, who actively participated in the forum discussions. The goal of the Secular Forum is to provide the concept, the construct and the compass to help us navigate global markets over the next three to five years. Crucial to this objective are the baseline, left tail and right tail scenarios we consider for the global economy and economic policy over that timeframe.

To set the stage for this year's forum discussion, we briefly reviewed the baseline scenario that emerged from last year's forum.

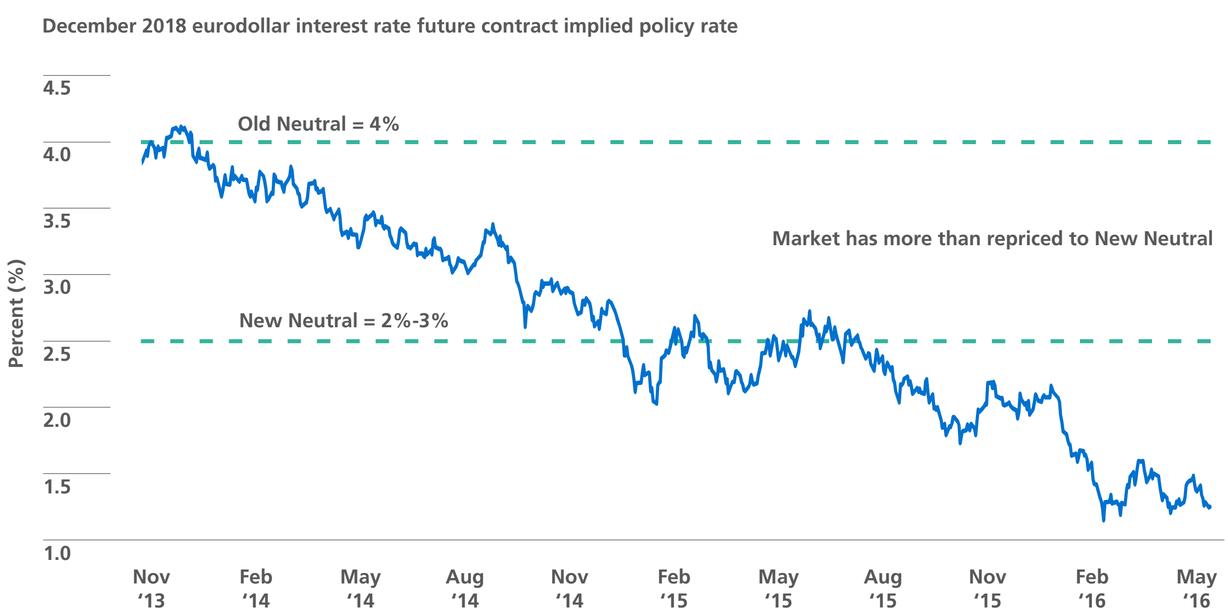
In May 2015, our baseline secular outlook saw central banks constrained by lofty leverage and sluggish growth to set policy rates at levels well below those that prevailed before the crisis, a continuation of our New Neutral thesis from 2014. For the eurozone and Japan, we expected equilibrium real policy rates would remain *negative* over most, if not all, of our secular horizon. For the U.S., we foresaw a gradual liftoff trajectory for the federal funds rate also fully consistent with The New Neutral, a liftoff trajectory that a year ago – and today – is (more than) priced in to financial markets (see Figure 1). We also saw a potential conflict between the Fed's desire to allow its balance sheet to shrink over time and its dual mandate objectives of supporting growth and pushing up inflation toward its 2% target, and observed that the Fed balance sheet was not on autopilot. Our baseline secular scenario last year saw a world of economies converging to modest trend growth trajectories, with output gaps narrowing – in some cases only very gradually – and with inflation rising toward target. We also identified key tail risks to the baseline scenario that, if realized, would produce a far different trajectory for the global economy. For example, we noted that, were the world economy to tip into a global recession, few countries outside the U.S. and China would have ample room to maneuver to deploy aggressive countercyclical policy. We also specifically cautioned that there "remains a tail risk of political polarization in the eurozone and/or a British exit from the European Union. In China, the planned reforms are ambitious, but success is not assured, and capital account liberalization in particular will be challenging to accomplish in the timeframe announced."

THIS YEAR'S QUESTIONS

As we gathered in Newport Beach for the 2016 Secular Forum, we knew that our New Neutral thesis was now more than fully priced in to financial markets. In fact, Fed officials themselves have discussed U.S. monetary policy in terms of a time varying "neutral" policy rate, which is currently and is expected for several years to remain (well) below its pre-crisis old neutral level. So an important goal of this forum was to develop a new secular framework appropriate for a world in which The New Neutral is expected to prevail and is fully reflected in asset prices. We also realized that we confronted many of the same questions that we did the year before: How robust is the global expansion in developed and emerging economies? What are the limits of unconventional monetary policy, and do the costs of such policies exceed the benefits? Are China's prospects for growth, exchange rate policy and capital account liberalization on track? We confronted new questions as well, about the prospects and risks for political polarization and fragmentation in Europe and the U.S., and the downside to negative interest rate policy in Japan and elsewhere.

> "The neutral nominal federal funds rate – defined as the value of the federal funds rate that would be neither expansionary nor contractionary if the economy were operating near potential – is currently low by historical standards and is likely to rise only gradually over time."
>
> – Federal Reserve Chair Janet Yellen, 16 December 2015

Figure 1: Market has more than repriced to The New Neutral



Source: Bloomberg data as of 10 May 2016

But while many of the questions might remain the same, a lot – to say the least – has happened since our last forum in May 2015, and we needed to decide based on what we learned from our invited speakers, our Global Advisory Board members and our first-year class of MBAs whether and to what extent we needed to reassess our baseline scenario as well as recalibrate the likelihood and rethink the particular consequences of different tail scenarios. We organized our agenda into four broad topics, also the four essential questions to frame our discussion:

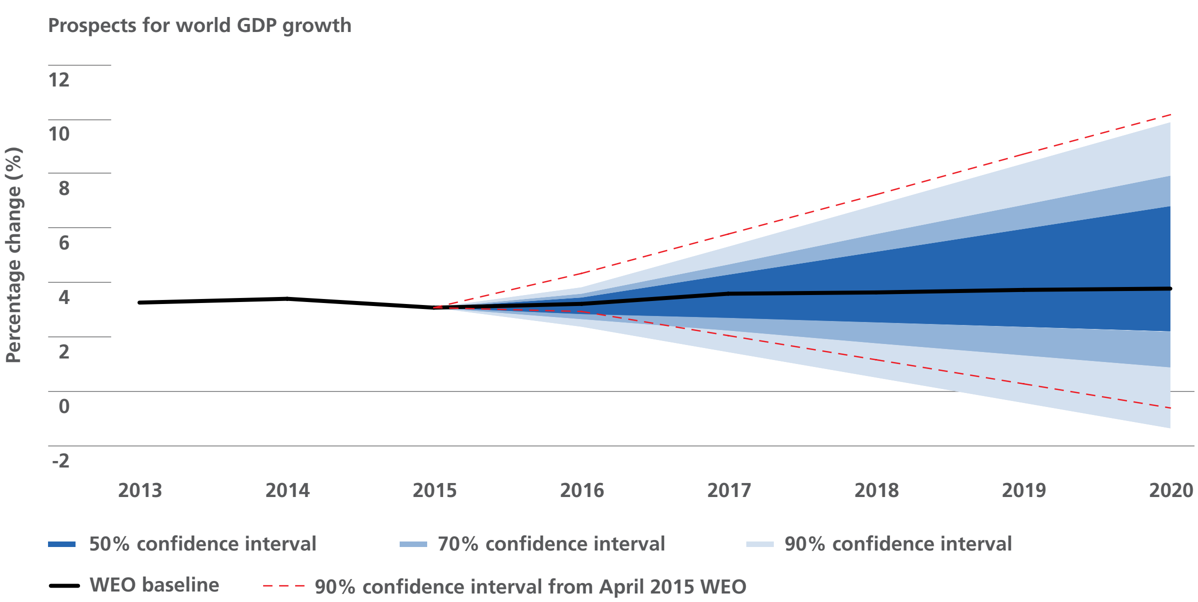
- The global economic outlook: Is last year's left tail this year's baseline? (See Figure 2 for IMF's view on this.)
- China: Is the journey as important as the destination?
- Monetary policy: Diminishing returns or dead end?
- Political populism and polarization: Flash in the pan or secular reality?

OUR SECULAR OUTLOOK

The focus of our internal discussion was on how to balance and reconcile the set of powerful forces that have been at work in the post-crisis global economy, to stress test and re-examine how likely they are to continue, and to assess what might happen if the baseline scenario for the global economy proves to be unsustainable. In these discussions, many of us found a useful framework in one of our guest speakers' notions that we face "radical uncertainty" about the future course of the economy, policy and markets, and the idea that "stability is not sustainability."

We agreed that we find ourselves today in a post-crisis global economy in which growth is just fast enough to avoid stall speed, but there is no evident or prospective source of productivity or organic demand that would support a baseline for more robust expansion. Deflation has been avoided and output gaps in many major economies are closing, but few if any major central banks today are even hitting their 2% inflation targets, let alone overshooting them. And so while the global economy has plodded along since 2009 and has thus far

Figure 2: IMF forecast for global growth has shifted down



Source: IMF World Economic Outlook, PIMCO as of April 2016

avoided tipping into another recession, the system has only averted collapse because of zero or even negative policy rates in many countries, the gusher of liquidity administered by major central banks via quantitative easing (QE), and the debt-financed investment boom in China and some other emerging market (EM) economies.

One plausible scenario, and indeed this remains the PIMCO baseline case, is that a version of this status quo simply continues and evolves gradually for the next three to five years. More specifically, our baseline view for the U.S. foresees GDP growth at or slightly above trend of 1.5% to 2% per year, inflation fluctuating around the 2% target, the Fed gradually lifting the federal funds rate to The New Neutral range of 2% to 3% nominal, and fiscal policy providing modest positive support to aggregate demand.

For the eurozone secular baseline, we foresee lackluster, trend-like growth of between 1% and 1.5% per year with inflation remaining somewhat below 2%. On policy, we see the European Central Bank continuing to do the heavy lifting and eventually even pursuing an extension of the QE program that will approach de facto if not de jure monetization of fiscal deficits. Our baseline sees modest positive support for European growth from fiscal policy over the next three to five years.

Finally, for China, our baseline is that of a managed slowdown, with growth between 5% and 6% and inflation around 2%. Under the baseline, leverage stabilizes in part through controlled defaults and with incremental state recapitalization of state-owned enterprises.

But the consensus in the room was that we should not take excessive comfort from this familiar refrain even if it does remain our baseline scenario. With the global recovery about to enter its eighth year, with central banks pushing even further into the realm of diminishing if not negative returns to unconventional policy, and with our secular window now open to the year 2020 and beyond, we considered another, more complex diagnosis: There is the distinct possibility that the left tail has gotten fatter, and that monetary policy exhaustion and an overhang of debt in some major economies pose material threats to the sustainability of the global recovery and financial stability. This is a left tail scenario and not our baseline view, but in contrast with our previous New Neutral thesis, we now believe that there is a material risk globally – if not necessarily for the U.S. – that the unconventional monetary policies in place today will be insufficient to maintain global growth, close output gaps and bring inflation to target. Furthermore, compared with the

2016 SECULAR FORUM GUEST SPEAKERS

Mervyn King
Governor of the Bank of England (2003–2013)
The End of Alchemy

David Dollar
Senior Fellow, Brookings Institution
The Outlook for China's Economy, Policy and Financial Markets

Doris Kearns Goodwin
Presidential Historian, Pulitzer Prize-winning Author
The 2016 U.S. Presidential Election

Olivier Blanchard
Former Chief Economist, International Monetary Fund
Fred Bergsten Senior Fellow, Peterson Institute for International Economics
The Outlook for Global Growth, Equilibrium Interest Rates, Aggregate Demand, Supply and Inflation

Charles Gave
Founding Partner and Chairman, Gavekal
Emerging Markets 2020 – What Lies Ahead

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pre-crisis experience, with trend growth slow and with debt levels high, there are no obvious "spare tires" available globally if and when monetary policy exhaustion threatens global stability. In other words, the global economy finds itself today in a state of disequilibrium that has remained stable thus far only via three policy props: zero or near-zero interest rate policy, QE, and levering up in China, some other EM economies and the European periphery. We concluded there are diminishing returns to all three of these policy props, while at the same time we believe the costs of unconventional policy are rising and the ability to maintain growth with ever-higher leverage in some countries is limited.

We also considered right tail scenarios for the global outlook, and focused our attention on possibilities for a rebound in global productivity – which would support higher investment, consumption and "animal spirits" – and possibilities for a shift in the global policy mix toward fiscal policy or even coordinated monetary-fiscal "helicopter money" programs. As for productivity, our guest speakers reminded us that inflection points in productivity growth are hard to predict, so while a rebound in productivity *might* happen in the next three to five years, and we could cite anecdotal evidence to support that belief, we did not see this right tail scenario as likely enough to affect the way we expect to invest.

Regarding helicopter money, we thought it very unlikely to happen in the U.S. over our secular horizon. By contrast, in Japan, there already appears to be a rather high degree of coordination between monetary and fiscal policy, and there are real prospects for even closer ties between the Ministry of Finance and the Bank of Japan in which the existing quantitative and qualitative monetary easing (QQE) program evolves into a Japanese government bond price-pegging program. The uncertainty surrounding the impact of helicopter money scenarios is especially radical.

Turning to more traditional fiscal policy options, the world's three major economies – the U.S., Germany and China – all have space to run more expansionary fiscal policies, and in a right tail scenario they do so and with a focus on infrastructure and the supply side.

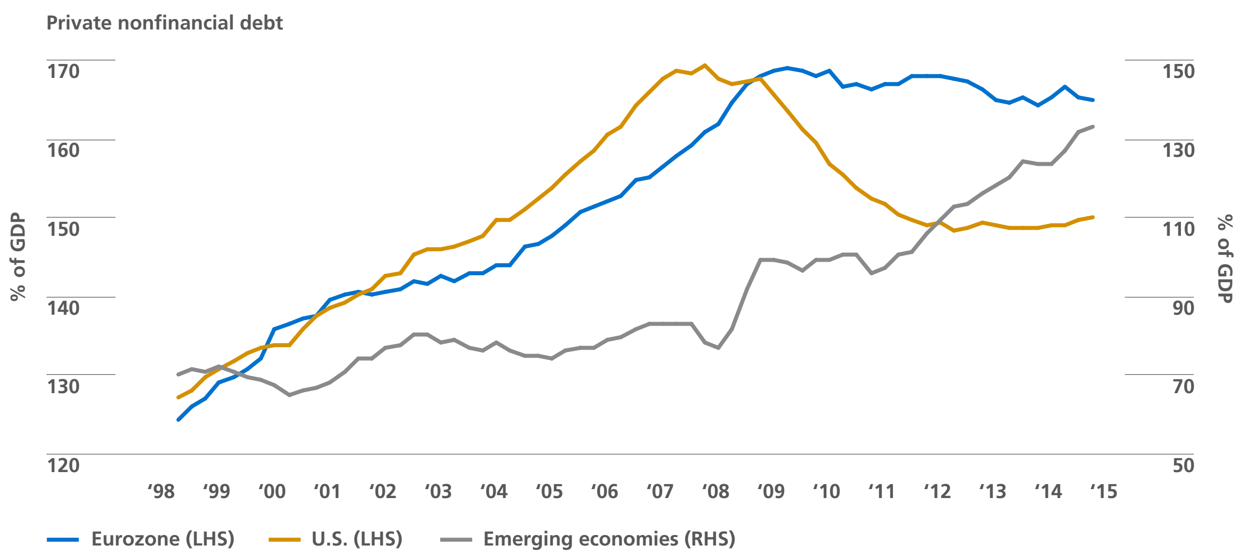
Finally, a potential positive for the global outlook in our baseline scenario is that the secular correction in commodity prices and the secular tailwind to the strong dollar appear to be largely complete.

In sum, our secular thesis is that with risks to global economic stability rising, investors should be compensated up front for the growing and heightened uncertainty and potential consequences of monetary policy exhaustion they face. Under a left tail scenario in which this stable disequilibrium unravels sometime and in some fashion during our secular horizon, no one has a crystal ball to determine what it would look like. The timing and precise dynamics of the eventual endgame following such a scenario are uncertain, the plausible paths are many and complex, path dependence would be the rule and not the exception, and much would depend on the timeliness and boldness of the policy – including fiscal policy – response. But while there are myriad uncertainties, there is no doubt that a global disruption of our baseline scenario would have serious repercussions for growth, inflation and financial markets. The risks are uncertain, but they are real, and active investors can aim to put a price on them.

Here we can learn another lesson from history: "A Stable Disequilibrium" was in fact the theme of our 2006 Secular Forum, and this was the way we had characterized the world in the years leading up to the global financial crisis. At that time, PIMCO was early and saw the world in a state of stable disequilibrium – supported by a surge of financial globalization and petrodollar recycling that fueled an unprecedented explosion in private sector borrowing, an era that today is referred to as "the great leveraging" that provided the financing for "the great moderation." Asset prices were distorted and traditional metrics for valuation were cast aside. Momentum made money, and contrarian investors, for a time, lagged behind. Nonetheless, as early as 2004 we had begun to prepare and position our portfolios for the eventual unwind, knowing full well that our crystal ball was opaque and that the stable disequilibrium, although doomed to collapse eventually, could persist for some time – as of course it did.

Although the situation today differs in many respects from the pre-crisis experience, there are some parallels. Global leverage is again exploding – via government budget deficits in the rich countries and private sector borrowing binges in some major EM countries (see Figure 3). Asset prices in some markets are distorted and traditional metrics of valuation are cast aside in a world of QE infinity, negative interest rate policies and subzero seven-year sovereign yields. Although global imbalances have declined and are shrinking, they have been more than replaced by ballooning central bank balance sheets as a source of liquidity and cheap finance for the chronically debt-addicted. This policy mix and the middling global growth and modest inflation it supports may remain our baseline scenario. But because we see the left tail risks as elevated, just as we did during the stable disequilibrium years before the crisis, we believe it makes sense coming out of this forum to prepare and position ourselves with this elevated macro risk in mind.

Figure 3: What deleveraging? Private sector leverage outside the U.S. remains high and rising



Source: Bank for International Settlements as of 30 September 2015

Investment implications

In a world in which stability is becoming increasingly unsustainable, how do we invest? These are some of the key secular themes that we expect to guide how we manage our clients' assets over the next three to five years.

Stay on dry land and preserve capital

In recent years we have described "riding a wave" of central bank interventions, as a range of unconventional policies have been rolled out across countries, driving asset price returns. This wave-riding has worked well in the past. Looking out over the secular horizon, however, diminishing returns to central bank interventions – and the potential for policy activism to do more harm than good, notably in the case of negative policy rates – advise against such an approach. Debt levels globally remain very high, and the more levered sectors are relying on (potentially less effective) central bank support. While our baseline secular outlook sees a fairly benign macroeconomic path and fairly range-bound markets, there are a range of downside risks (discussed in detail above), including China and the eurozone, monetary policy exhaustion, political gridlock and the rise of populism. These potential shocks to the global economy increase the prospects for permanent debt write-downs over the secular horizon. Overall, we expect to have more cautious positioning in our portfolios, and to make capital preservation the number-one priority. It will be critical to target high quality income-generating assets in our portfolios but not necessarily the highest-yielding assets – we will tend to look for structural seniority, and we want to see sufficiently strong fundamentals or hard asset coverage to help investments weather the uncertainties over the secular horizon. We cannot rely solely on central bank support. The secular timeframe is likely to remain a very difficult environment for investing, and we will seek to avoid investments where there is a real risk of permanent capital loss.

Guard against negative yields and guard against the asymmetric risk of rising yields

Markets now price in The New Neutral outlook for central banks and for market rates, which has been a central theme of our secular outlook for the past two years. Over the coming secular horizon, we will guard against negative yields in Japan and the eurozone, looking for more attractive global alternatives. Overall in our baseline outlook we expect government bond market yields to be fairly range-bound, but there is a clear asymmetric risk toward higher yields than those priced into forward curves.

Grind out alpha in a low return environment

The combination of fixed income markets that price in The New Neutral and fairly full equity valuations means we are operating in a low return environment. This reinforces the importance of active management, with alpha set to be a higher proportion of total return than during the secular bull market. We see this as an environment in which active managers can improve upon low passive returns. We believe critical decisions have evolved beyond the straightforward *how much* of a given asset class, sector or region to own in a portfolio, and instead see a need for greater discretion in selecting *what* to own. Also, we reaffirm the importance of PIMCO's long-term tradition of structural alpha positions, which seek to benefit from exploiting market inefficiencies and provide a diversified source of return from other top-down and bottom-up active positions.

Seek to benefit from periods of high volatility

The outlook for growth at the global level and across globally important countries and regions we see as subject to fairly normal, bell-shaped distributions. But this fairly normal outlook reflects a very unusual level of central bank and other policy interventions. Market valuations range from fair to stretched and remain highly influenced by central bank interventions. As the Federal Reserve looks to unwind stimulus and other countries, notably Japan, get further and further into extreme intervention territory, the margin for error is thin. The experience of the past years has shown that it does not take much in terms of policy actions and mistakes to prompt repricing in markets. While maintaining overall fairly cautious portfolio positioning, we will seek to benefit from periods of volatility in which assets have the potential to cheapen significantly. To be in a position to benefit, we will need careful portfolio construction and rigorous risk management of our positions.

Very selective on the eurozone

The eurozone secular outlook in particular is subject to a series of risks – economic, political and regulatory – and significant uncertainty over the reliability of property rights and the protection of the rule of law (recent examples of the latter include Portugal and Austria). In recent years we have favored eurozone markets with a secular bias to be overweight but, at current valuations and given the risks to the outlook, we expect to be cautious and very selective on eurozone holdings in our portfolios.

Look for opportunities in emerging markets

Two of the key challenges to emerging markets in the past few years have been the strength of the U.S. dollar and the weakness of commodity prices. Our secular outlook of broad stability for the U.S. dollar, in part owing to China's constraint on Fed policy tightening, along with commodity markets that have largely repriced to China's reduced and less commodity-intensive growth path suggests that two key negatives for emerging markets have been removed. While there are of course country-specific challenges in emerging markets, and liquidity conditions have deteriorated, we will look on a country-by-country and sector-by-sector basis for good investment opportunities in emerging markets.

Bottom-up over beta

In credit markets, where market beta valuations look fair but not cheap, we will seek to add value using our global team of credit portfolio managers and credit analysts, focusing on picking the winners and avoiding the losers in the capital structure and investing in industries and companies where we perceive pricing power and barriers to entry.

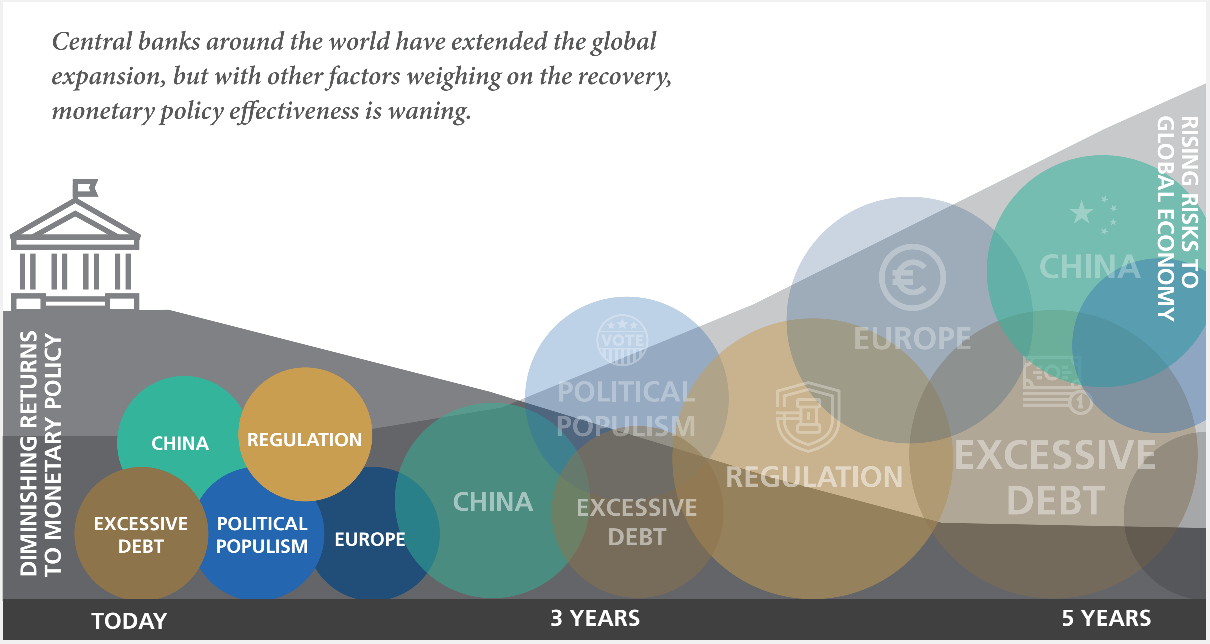
Scour the world and diversify

We will scour the world for investment opportunities across sectors, using our global team of 295 portfolio managers and analysts. We will look to take a wide range of diversified positions and to identify attractive liquidity and complexity premiums – and we will strive in portfolio construction and risk management to guard against excessive correlated risk in our portfolios.

Guard against the right tail

As well as seeking to protect against left tail risks, we need to seek to protect against right tail risks, given the possibility of better-than-expected macro outcomes – notably inflation, which, along with default risk, constitutes in our opinion the biggest risk to fixed income portfolios, particularly at very low levels of real and nominal yields. Given the extent of increasingly experimental monetary policies in place globally (with the potential for more to come), all with a core objective of boosting inflation rates, we find inflation protection is attractively priced. Different countries face a range of potential inflation outcomes, but we see U.S. Treasury Inflation-Protected Securities (TIPS) as offering both good value and valuable protection against the possibility of higher inflation in the U.S. Risk management will be crucial to investment outcomes over the secular horizon.

Rising Risks?



INVESTMENT RISKS

Left tail risks are building, with consequential implications for portfolios.

In the absence of structural reforms, we are approaching the limits of central bank policy.

Increasingly experimental policy is creating greater uncertainty and stretching valuations.

Unsustainable debt levels mean that long-term risks of capital impairment or inflation are rising.

Political uncertainty is increasing.

Greater regulation and related reduced transactional liquidity are enhancing local market volatility.

… AND RESPONSES

Be patient.

Be tactical and flexible.

Provide liquidity when others need it.

Prepare for market turning points. This is one of the key advantages of active management.

Avoid or underweight assets that solely or primarily rely on central banks to support valuations.

Hedge against a tail scenario in which inflation overshoots central bank targets.
Although this is unlikely in the near term, the risk is significant over our secular horizon.

ABOUT OUR FORUMS

PIMCO's investment process is anchored by our Secular and Cyclical Economic Forums. Four times a year, our investment professionals from around the world gather in Newport Beach to discuss and debate the state of the global markets and economy and identify the trends that we believe will have important investment implications. We believe a disciplined focus on long-term fundamentals provides an important macroeconomic backdrop against which we can identify opportunities and risks and implement long-term investment strategies.

At the Secular Forum, held annually, we focus on the outlook for the next three to five years, allowing us to position portfolios to benefit from structural changes and trends in the global economy. Every Secular Forum, we invite distinguished guest speakers – Nobel laureate economists, policymakers, investors and historians – who bring valuable, multi-dimensional perspectives to our discussions. We also welcome the active participation of the PIMCO Global Advisory Board, a team of five world-renowned experts on economic and political issues.

At the Cyclical Forum, held three times a year, we focus on the outlook for the next six to 12 months, analyzing business cycle dynamics across major developed and emerging market economies with an eye toward identifying potential changes in monetary and fiscal policies, market risk premiums and relative valuations that drive portfolio positioning.

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Tony Crescenzi

Mr. Crescenzi is an executive vice president, market strategist and generalist portfolio manager in the Newport Beach office of PIMCO. He is also a member of the Investment Committee. Prior to joining PIMCO in 2009, he was chief bond market strategist at Miller Tabak, and worked for both Lehman Brothers and Prudential Bache. Mr. Crescenzi has written five books, including "The Strategic Bond Investor" and "Beyond the Keynesian Endpoint." He regularly appears on CNBC and Bloomberg television and in financial news media. Mr. Crescenzi taught in the executive MBA program at Baruch College from 1999-2009. He has 33 years of investment experience and holds an MBA from St. John's University and an undergraduate degree from the City University of New York.