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.

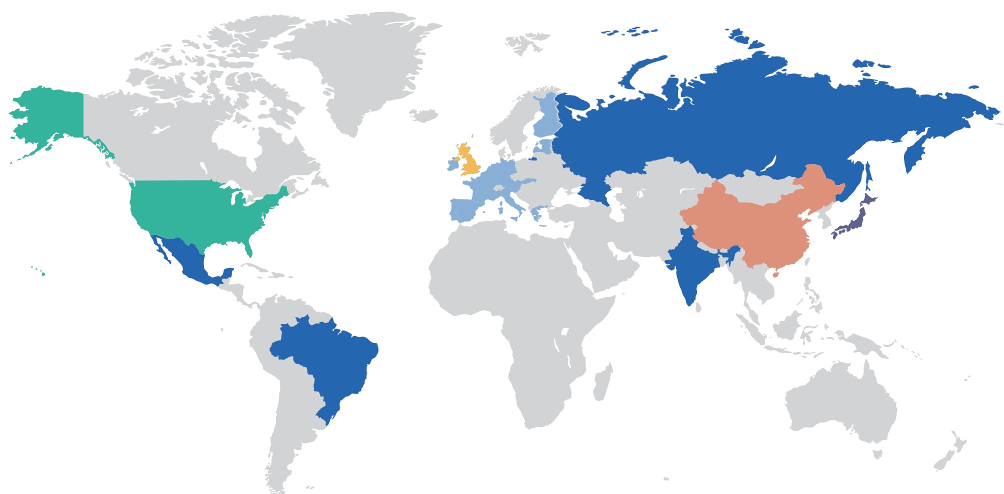
Somewhat encouragingly, judged by the ECB's easing package announced shortly after our forum, central banks appear to have begun harboring the same kind of doubts about the efficacy of negative interest rates and are now adjusting their toolkit yet again. The ECB added a larger credit easing component 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)



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%**

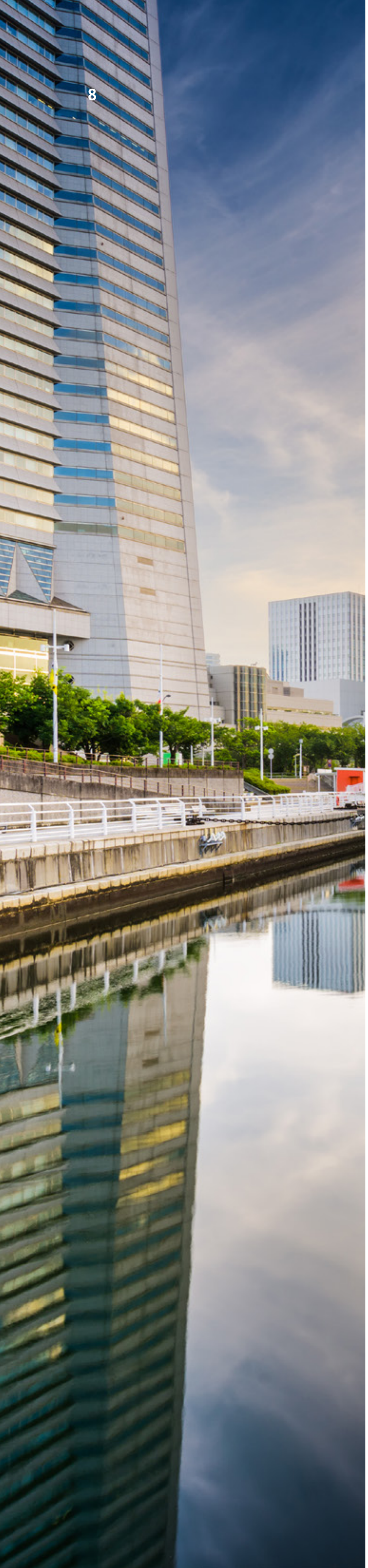
[1] 2015 data for real GDP and inflation represent calendar year averages
[2] BRIM is Brazil, Russia, India, Mexico
[3] World is the GDP-weighted average of countries listed in table above
Source: Bloomberg, PIMCO calculations. Note: Forecast for 2016 is as of March 2016 Cyclical Forum.

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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