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Each quarter, PIMCO investment professionals from around the world gather in Newport Beach to discuss the firm’s outlook for the global economy and financial markets. In the following interview, Josh Thimons, chairman of PIMCO’s Americas Portfolio Committee, discusses PIMCO’s cyclical outlook for the U.S. in 2013 – a year when fiscal drag will be balanced by housing growth and less fiscal uncertainty.

Q: PIMCO expects the U.S. economy to grow 1.5%–2% in 2013. What will be the main drivers?

A: We expect the largest contributors to U.S. growth this year will be housing and related industries, increases in capital expenditures (albeit from very depressed levels), certain manufacturing sectors, such as the auto industry, and the energy sector.

We see housing contributing 0.7 percentage points to overall GDP in 2013, and we expect housing starts to rebound to a 1.1 million annualized rate by the end of the year.

In 2012, uncertainty surrounding the “fiscal cliff” had many corporations reluctant to increase spending. Now that most of the big questions in Washington have largely been addressed – if not necessarily resolved – there is somewhat less near-term uncertainty, and we expect companies that have been holding back on capex to start investing some of the record amounts of cash they have on hand.
That is not to say there is no fiscal drag from federal government actions; it’s just not as much as people had feared for a number of reasons. We see roughly 1.7 percentage points of drag on GDP coming out of Washington – far less than the four to five percentage points of potential drag had there been no fiscal cliff resolution. Without fiscal drag in 2013, the economy would be growing around 3% based on our forecast, which is respectable, and would have represented the strongest growth in the post-crisis era.

Q: You mentioned the housing recovery. How do you see that playing out over the next several years?

A: The recovery in housing is likely more of a cyclical than a secular story; we expect these levels of growth only for the next year or two. There are several reasons for this.

Fundamentally, we do not think the U.S. will ever return to the kind of housing euphoria that led up to the crisis. Speculative housing investors and lenders alike have learned their lesson. Due to both regulatory changes and stricter internal controls, the underwriting process for mortgages has changed permanently – we’ll never see so much easy credit in the financial system again. Finally, monetary policy, which is clearly supporting the housing market, can only remain this accommodative for a certain period of time. The bottom line is we don’t see this as a housing recovery that will be sustainable over the long term, or be able to lift the entire U.S. economy out of its low growth dynamic.

Q: Companies in the U.S. are sitting on a lot of cash. Why isn’t it finding its way into the real economy?

A: There’s no question corporate balance sheets are extremely healthy. And that’s important because it’s a risk factor that could surprise on the upside. However, while we see some increase in corporate capex in certain sectors this year – again, from depressed levels – we are not seeing any evidence of the magnitude of corporate capex spending that one would expect at this stage of a recovery and with the incredible monetary support being provided by the Fed. Instead, companies are buying back stock, engaging in mergers and acquisitions, and saving.

If U.S. growth surprises to the upside this year, it will be because corporations decide to put that cash to work. That said, we believe the primary reason corporations are sitting on this cash is because global business leaders sense a lack of aggregate final demand: Global consumers simply are not nearly as healthy as corporations.

Q: Short-term political instability has subsided somewhat. What does this mean for the markets and economy?

A: We see two key takeaways from the recent fiscal policy developments. The first we already discussed: We believe the ultimate outcome of the so-called fiscal cliff and sequestration will lead to drag of roughly 1.7 percentage points of GDP in 2013, not the catastrophic four to five percentage points some have feared. That said, fiscal policy is still the strongest headwind we see for the U.S. economy in the coming years.
Second, on a more optimistic note, a lot of the political uncertainty has abated. The positive tone in the markets during the first few months of 2013 reflects that. We are past the fiscal cliff, and while we didn’t necessarily get the best solution, we got a resolution. In fact, the majority of the tax cuts were made permanent for most Americans, which means we shouldn’t have to deal with another fiscal cliff in 2013. And while there has been some rhetoric lately about the debt ceiling, we do not expect the brinksmanship we saw in 2011, as Republicans have largely determined that the debt ceiling is not a popular political battle to fight. Finally, Congress has passed the continuing resolution on the budget, so the threat of the government shutting down is off the table for now.

The outcomes of these fiscal issues are far from optimal – we would have preferred to see a bipartisan solution that addressed both tax reform and long-run entitlement spending in a manner that avoided short-term fiscal contraction. Nonetheless, we no longer see the possibility of a fiscal catastrophe. We had been living from crisis to crisis, and now we have a measure of stability.

Q: What are your expectations for Fed policy? How effective can it continue to be?

A: Our growth expectations in 2013 are critically dependent on the continuation of the Fed’s extraordinary and experimental monetary policy. In addition to supporting cyclical growth via low interest rates, the Fed has boosted many asset prices – in some cases to artificially inflated levels. However, we are concerned this policy support will become increasingly ineffective.

We believe the Fed will continue with hyperactive monetary policy, which we now call “QE Infinity” – distinguished from the other quantitative easing programs in that it does not have an explicit end date or program size. We believe the Fed recognizes the decreasing effectiveness of its programs and is increasingly analyzing the costs versus the benefits of its policy, and the balance is shifting. The Fed has highlighted the risk of market disruption if it owns too much of the Treasury or mortgage-backed security markets, along with the risk of negative remittances to the Treasury, which could potentially become a political issue that leads to questions about the Fed’s mandate and political independence.

Finally, there is concern that the Fed not only gets the inflation it is looking for – but also more inflation than desired. Our outlook is for an on-target core inflation rate of 2% for 2013 in the U.S., but we also now see a much higher risk of higher inflation than deflation down the road.

Fed Chairman Bernanke has made it perfectly clear that the Fed needs to see substantial and sustained improvements in the labor market and irrefutable evidence the economy is healing before it will consider removing the policy prescription. As such, the risks are that the Fed makes the mistake of staying too easy for too long rather than making a “hawkish” mistake of prematurely withdrawing monetary accommodation.

Q: In light of PIMCO’s outlook, what are the investment implications for the year ahead?

A: Over the cyclical horizon, we have a favorable view of assets linked to the housing recovery. Non-agency mortgages, despite the strong showing recently, may still offer investors significant risk-adjusted value. And given our inflation outlook, we also continue to see value in owning inflation-protected securities and certain commodities. Since we continue to expect highly accommodative
monetary policy, we also still like the five- to 10-year part of the Treasury curve, which we believe will be most supported by the combination of the Fed’s forward interest rate guidance and asset purchases. We prefer underweight positions in longer dated Treasury securities, which we believe are more at risk to inflation and carry a higher risk premium due to the unknown future consequences of the experimental Fed policy. In addition, given the artificially suppressed real yields, unfavorable debt dynamics and long-term fiscal unsustainability within the U.S., we are looking for opportunities outside the U.S.: investing in duration in sovereign debt markets where there are superior debt dynamics and higher real yields, such as Mexico, Brazil and Australia.

All investments contain risk and may lose value. Investing in the bond market is subject to certain risks, including market, interest rate, issuer, credit and inflation risk. Mortgage- and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government-agency or private guarantor, there is no assurance that the guarantor will meet its obligations. Sovereign securities are generally backed by the issuing government. Obligations of U.S. government agencies and authorities are supported by varying degrees, but are generally not backed by the full faith of the U.S. government; portfolios that invest in such securities are not guaranteed and will fluctuate in value. Inflation-linked bonds (ILBs) issued by a government are fixed income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Commodities contain heightened risk including market, political, regulatory and natural conditions, and may not be suitable for all investors. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their financial advisor prior to making an investment decision.

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