Calmer C's Ahead?
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SUMMARY

- At the Cyclical Forum in early March, PIMCO investment professionals from around the world gathered to analyze business cycle and policy dynamics across major developed and emerging economies and identify the trends that we believe will have important implications for investors.
- While markets have largely rebounded from the correction at the beginning of the year, we have lowered our forecast for 2016 for global growth and inflation. We do not expect a global or U.S. recession over the cyclical horizon, with more encouraging signs from China, commodities and central banks – but each of those three could surprise investors.
- Market valuations in general look fair to full, but there are still pockets of value following the recent bout of market volatility. We expect more volatility ahead.

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.
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.
U.S. economy: Zeroing in on two percent
Eurozone and UK: OK growth, tricky politics
Japan: Lackluster growth and inflation
China: Challenging transition, all eyes on capital outflows

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

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 also 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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