

Secular Outlook
May 2015

The New Neutral Revisited

ACTIVE INVESTING FOR THE SECULAR HORIZON

There are reasons to be cautiously optimistic about the outlook of the global economy. This is one of the distillations from our Secular Forum in May in which PIMCO's investment professionals gathered to review and assess the landscape of the global economy, financial markets, economic policy, and geopolitical flashpoints. Our goal was to develop a construct that the firm can use over the next three to five years to navigate global markets and invest wisely on behalf of our clients. Among other things, we revisited our theses of The New Neutral and The New Normal.



AUTHORS

Andrew Balls
*Chief Investment Officer,
 Global Fixed Income*

Richard Clarida
Global Strategic Advisor

Daniel Ivascyn
*Group Chief
 Investment Officer*

**2015 SECULAR FORUM:
GUEST SPEAKERS**

Our distinguished speakers bring fresh perspectives to challenge our internal expertise. Nobel laureate economists, policymakers, and historians have all injected valuable insights into our discussions over the years, providing a multi-dimensional perspective. This forum's speakers were:

Dr. Anat Admati
 Professor of Finance and Economics
 at Stanford

Robert Arnott
 Founder and Chairman of Research
 Affiliates, a subadvisor to PIMCO

Dr. Ben Bernanke
 Former Chairman of the Federal Reserve,
 PIMCO Senior Advisor

Dr. Gary Gorton
 Professor of Management and Finance
 at Yale

Leon Panetta
 Former U.S. Secretary of Defense and
 Central Intelligence Agency Director

Jean-Claude Trichet
 Former President of the European
 Central Bank

Dr. Daniel Yergin
 Pulitzer Prize-Winning Author and Leading
 Expert on Energy and Geopolitics

Revisiting our views is one of the factors that makes our Secular Forum such an integral part of our investment process, as it has been for more than 30 years.

Another reason is that we challenge and refresh our thinking by inviting and engaging with distinguished guest speakers. This year's list (shown in the sidebar) included Jean-Claude Trichet, Leon Panetta and others, and we also benefited from the active participation of PIMCO advisors Ben Bernanke, Mike Spence and Gene Sperling, and from three superb presentations from our class of new MBAs and PhDs.

We began the forum on May 18 knowing we would need to answer several big questions to get our secular call right:

- *The global economy is living with leverage and has required "six-sigma" doses of unconventional monetary policy to generate sluggish, "one-sigma" growth. Will this continue and, if it does, is it sufficient to keep the system going? If so, what is the destination? If not, what are the consequences?*
- *Can the post-crisis global financial system support the credit intermediation required to fund the New Normal global economy? What are the trade-offs between a safer system and less liquid markets?*
- *Has the left-tail risk of global deflation been clipped? What is the right-tail risk of the policies deployed to avoid it?*
- *Chaos in the Middle East and confrontation in Ukraine have been taken in stride by markets and the global economy, but can this continue? Or are markets too complacent?*





Context and initial conditions

As is the case at any PIMCO Secular Forum, we have three choices: reaffirm our existing secular thesis, refine that thesis or – if circumstances warrant – replace that thesis. The New Neutral thesis that emerged from the 2014 PIMCO Secular Forum foresaw a multi-speed world of economies converging to modest trend growth trajectories. We also described an ongoing overhang of public and private global leverage, the potential for the U.S. economy to surprise on the upside, monetary divergence between countries escaping the zero bound and those remaining stuck there, and a re-regulated global financial system that is potentially safer but offers less dynamic growth and provides less liquidity to markets.

We concluded then that for the next three to five years we will be living in a New Neutral world in which monetary policymakers will set short-term interest rates at levels below, in many cases well below, the rates that prevailed before the global financial crisis. We saw The New Neutral thesis as the natural evolution of The New Normal construct that PIMCO introduced in 2009. But whereas The New Normal described a two-speed world of a global economy recovering from crisis and facing a headwind of de-leveraging, The New Neutral refined that thesis to apply to a multi-speed world of countries *converging* to slower trend growth trajectories while living with leverage, but doing so only with the support of monetary policy rates set at historically low, New Neutral levels.

Since our last forum, The New Normal/ New Neutral construct has been adopted by policymakers and, in some cases, priced into financial markets. For example, here is Chinese Premier Li Keqiang speaking at the National People's Congress in Beijing on March 5, 2015 (emphasis added):

“In order to defuse problems and risks, avoid falling into the ‘middle income trap,’ and achieve modernization, China must rely on development, and development requires an appropriate growth rate. At the same time, China’s economic development has entered a **New Normal** ... ”

Or consider this observation by Federal Reserve Chair Janet Yellen speaking at *The New Normal for Monetary Policy* research conference hosted by the Federal Reserve Bank of San Francisco on March 27, 2015:

“The equilibrium real federal funds rate is at present well below its historical average and is anticipated to rise only gradually over time as the various headwinds that have restrained the economic recovery continue to abate. If incoming data support such a forecast, the federal funds rate should be normalized, but at a gradual pace.”

In her comments, Chair Yellen refers to the “equilibrium” federal funds rate, which is her term to describe what we and others have called the “neutral” monetary policy rate. What do markets price in for this equilibrium rate, and how has this pricing evolved over time?





The chart shows the implied yield on the December 2018 eurodollar futures contract, one proxy for where the market expects the Fed's policy rate to end up when the next rate hike cycle has concluded. In January 2014 this proxy for the terminal policy rate was about 4%, almost spot on with the "old neutral" idea that the Fed should anchor policy at a rate equal to the sum of the 2% inflation target and the estimated old neutral real rate of interest, which was thought to be 2%. Since then, the implied yield on this December 2018 futures contract has declined steadily and, at close to 2.5%, is right in the middle of the range we estimate for The New Neutral.

What's ahead: A New Neutral baseline scenario

In some important respects, our baseline views on the secular outlook have not materially changed since the previous PIMCO Secular Forum in May 2014. We continue to see a multi-speed world of economies converging to modest trend

growth rates, a view now shared by the International Monetary Fund, which, in its most recent world economic outlook, materially marked down its estimates of potential growth in both developed and emerging economies. We also see a global economy that is no longer restrained by private sector de-levering but, instead, is learning to live with record levels of public and private debt without a cushion that would be provided by more rapid growth or higher inflation than we foresee.

While the left-tail threat of *deflation* in Japan and the eurozone has diminished due to six-sigma QE programs put in place by the European Central Bank and the Bank of Japan (and in the case of the ECB an additional negative interest program in which banks are charged for the excess reserve balances on deposit at the central bank), we do not in our baseline foresee an imminent rise in prices toward the 2% inflation targets these central banks aim to achieve. Regarding financial markets, we

participate in a global financial system that is better capitalized than before the crisis, and perhaps less vulnerable to a systemic run, but understand that it offers less liquidity to investors and appears more susceptible to "flash crashes" and "vapor locks" as the global balance sheet available for market-making shrinks.

For all these reasons, we **continue to believe that we are now, and will be for some time, operating in a New Neutral world in which central banks will be constrained to set policy rates at levels well below those that prevailed before the crisis.** In the eurozone and Japan, where we expect neutral real policy rates to be **negative** over most if not all of our secular horizon, we judge both the ECB and the BOJ leadership to be "all in" in their attempts to reflate their economies and to be willing to continue unconventional monetary policies for as long as it takes to move as close as possible to their 2% inflation targets. What about the Fed? As

The Implied Future Fed Policy Rate Has Declined to a New Neutral Level

December 2018 eurodollar interest rate futures contract implied policy rate

Percent (%)



Source: Bloomberg as of 29 May 2015



discussed earlier, the markets have fully priced in a New Neutral path of Fed policy rate normalization, and on May 22, in the same week as our forum, Chair Yellen said it could take several years for the Fed to complete the forthcoming rate hike cycle once it finally commences, most likely later this year. The Fed would also like to shrink its balance sheet by allowing mortgage-backed securities to prepay and Treasuries to mature without replacing them with new purchases in the secondary market. That is the plan. But as we discussed at length during our forum, we do not think the Fed's balance sheet is on autopilot. The Fed's objective is to sustain economic expansion and bring inflation up to the 2% target. It would like to do this in tandem with shrinking its balance sheet as it gradually normalizes short-term interest rates, but if the former were to cause long-term yields to spike, we judge that the Fed would, if necessary, recalibrate the pace of balance sheet normalization so as not to compromise its dual mandate objectives.

Trends to follow, tails to hedge

After hearing from our invited speakers and following a robust internal discussion among PIMCO investment professionals, our Investment Committee met the morning after the forum to compare notes and to assess agreement on key themes. As we did so, a conceptual framework began to emerge, one that recognizes six key trends that are likely to define the global opportunity set available to investors and the returns they can expect over a secular horizon.

However, while we believe identifying and investing in these secular trends will be *necessary* to succeed, it will likely not be sufficient to deliver robust returns in the global economy and markets as they evolve. Investors will need to identify and hedge against six important secular tails as well.

Six trends driving global markets

- 1 *Converging to New Normal potential growth rates in developed and emerging economies.*
- 2 *Evolving to a re-regulated, better capitalized global banking system.*
- 3 *Moving from energy scarcity to energy abundance unlocked by the shale revolution.*
- 4 *Accelerating from deflation and toward targeted 2% inflation in the major economies.*
- 5 *Shifting (a nascent trend) from a global savings glut supported by lower commodity prices and toward narrowing global imbalances amid stronger global demand, which will depend to some extent on whether China can succeed in making the middle income transition.*
- 6 *Implementing (another nascent trend) better economic policy in key emerging economies (China, India) as well as key developed economies (eurozone, Japan) with at least the possibility of future breakthroughs in U.S. economic policy (immigration, oil exports, trade promotion authority).*

Six key tail risks to the secular trends

- 1 *With trend growth rates and inflation modest, policy rates low, public balance sheets bloated and public debt high, few countries would have room to maneuver to deploy countercyclical policy were the global economy to go into recession within the next five years.*
- 2 *The re-regulated, better capitalized global banking system allocates little of its balance sheet to making markets, resulting in greater likelihood of flash crashes, air pockets and trading volatility.*
- 3 *The trend away from energy scarcity and toward energy abundance creates big losers as well as winners and is only a net positive for global demand if the winners' boost in consumption offsets the losers' cut in consumption and capital spending.*
- 4 *Geopolitical conflicts have thus far been taken in stride by markets, but "disaster risk" is to some extent priced into financial assets today and is a source of volatility and downside risk to equity prices and credit spreads and upside potential to Treasury and Bund prices.*
- 5 *The distribution of global inflation outcomes has a right tail as well as a left tail; over our five-year horizon, a breakout of inflation to the upside of central bank inflation targets is not as unlikely as many seem to assume.*
- 6 *A trend is called nascent for a reason – there is a risk it does not develop – and there is risk to our optimistic baseline that foresees better economic policy in key emerging and developed economies and the possibility of future breakthroughs in U.S. economic policy over our secular horizon. 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 time frame announced.*

INVESTMENT IMPLICATIONS

Our 2015 Secular Outlook is a continuation of The New Normal/New Neutral, but valuations have changed. A year ago, markets were pricing in central bank policy rates above the levels implied by our New Neutral framework for the next three to five years. Today, markets have fully priced in The New Neutral and in some cases there may be insufficient risk premium. The New Neutral remains an anchor for fixed income valuations, but we expect to maintain a cautious stance on developed country duration in our portfolios. The six global trends we identify suggest the baseline of a gradual rise in yields/re-establishment of term premia in global fixed income markets. The six risks suggest that this will be a slow and, most likely, bumpy secular journey.

Inflation-protected securities

In the U.S., the major developed country that is the furthest advanced in its post-crisis normalization, we remain concerned that the market is pricing in insufficient risk premium for the impending Federal Reserve tightening cycle. The New Neutral framework provides an anchor but not a ceiling in terms of our expectations for Fed policy rates. While we expect an elongated economic cycle and growth close to potential, the two-sided risks we identify on inflation reinforce caution on nominal interest rate duration and also mean that we continue to favor U.S. TIPS (Treasury Inflation-Protected Securities) as a source of valuable inflation hedging at reasonable prices.

European bonds

European bond yields have been driven to very low levels by a combination of cyclical concerns of deflation risk, anticipation of scarcity in the face of ECB QE and concerns over the stability of Europe's monetary union. Based on our expectations of mild and gradual

reflation in the eurozone, core European country yields are secularly rich but cyclically may be subject to periods of downward pressure including ECB QE, sluggish growth and the risk of political fragmentation.

Corporate credit

Corporate credit market valuations remain well-supported by solid fundamentals, and we are generally positive on the secular credit outlook given the favorable longer-term trends we identify. Still, credit market valuations, while broadly fair, are certainly not cheap. We will continue to look to our credit portfolio management and research specialists for bottom-up alpha-generating security selection, while guided by our overall secular framework.

Managing liquidity

Making sure that we are paid appropriately for liquidity and managing liquidity in our portfolios will remain important secular considerations across the board and notably in credit markets. We are operating in a less risky world in terms of leverage in the banking system and, at the global level, with a far smaller shadow banking system. However, a by-product of increased regulation and lower leverage is that banks/brokerages are less able to function as market makers. We anticipate ongoing periods of market volatility that investors must be prepared for and that, in turn, will offer opportunities for active managers when volatility pushes securities prices away from the underlying fundamentals.

Equities

Our New Neutral rate expectations support a relatively constructive view on equities. Low discount rates, recovering but muted inflation and a drawn-out business cycle argue for positive equity performance – even at what are currently full valuations from a historical perspective. The global trends we

identify should support corporate earnings and, as with corporate credit, the secular trends provide a framework for picking winners by region and sector. In emerging markets, we will look for opportunities to invest in countries with improving growth profiles and economic governance reforms and see the potential for EM equity outperformance.

Commodities

The commodity supercycle is over, as is the correction due to the supply response over the last couple of years, in our view. Although commodity prices are unlikely to see big swings over the secular horizon, they will continue to play their role as a portfolio diversifier and inflation hedge. Another implication is that headline inflation should more closely track core inflation, affording greater clarity to central banks in their inflation targeting.

Emerging markets

In emerging markets, we will continue to stress country-by-country analysis and active management over acronyms. Compared with developed country fixed income markets, emerging markets offer attractive secular valuations in a number of cases, in spite of cyclical headwinds.

Currencies

On currencies, in our secular outlook a year ago we identified the potential for U.S. dollar appreciation given the U.S.'s leading position among the major developed country economies in The New Neutral multi-speed world. Given the substantial moves since then, with the U.S. dollar some 15% stronger on a broad trade-weighted index, expectations for further dollar appreciation must be far more modest. But we continue to expect some further gradual appreciation of the U.S. dollar, particularly with the Federal Reserve set to be the first major central bank to embark on a New Neutral tightening cycle.

Active management

Valuations across markets that look fair and, in some cases, stretched underline the need for realistic asset market return expectations. Extraordinary policy actions by central banks have worked in part by pulling forward future returns and are now embedded in today's prices. In this environment, alpha generated by active managers will be an even more important part of total return as prospective returns across all asset classes are likely to be much lower than long-term averages. Investors who pursue a full opportunity set and emphasize flexibility to access the best global alpha opportunities should be well-rewarded in The New Neutral environment.

Alternative assets

In addition to alpha generation in active benchmark strategies, absolute return strategies, including a suite of alternative products, may provide a way to exceed these New Normal return expectations. In addition, we anticipate a growing role for private credit vehicles for long-term investors looking to harvest identifiable credit and liquidity premia.

Summary: A cautious stance

Our secular outlook rests on the expectation that central banks will remain accommodative and supportive of growth. Policy rates will remain low, and we expect the ECB and the BOJ to remain active in promoting reflation. In the U.S., while the Fed will gradually tighten policy, desire to shrink the balance sheet will be weighed against desire to avoid tightening financial conditions too much. While we expect convergence toward potential growth rates, and longer business cycles than the historical norm, caution is warranted to the degree that low policy rates, expanded central bank balance sheets and high government debt levels mean there is limited scope for policy-makers to respond aggressively in the face of business cycle downturns or shocks to investor confidence.

We see market valuations across fixed income and equity markets as broadly reasonable and, in our baseline, expect improving economic fundamentals to support valuations for riskier assets. But there is a danger that an ongoing low-yield and low-return environment will encourage excessive risk taking as investors reach for yield to try and maintain old normal return targets. This was a risk we sought to protect our clients against in the run-up to the 2008 global financial crisis, and we will be on guard again over the next few years.

We expect there will be ample opportunities over the secular horizon for PIMCO, as an active manager, to deliver returns and manage risk on behalf of our clients. In a New Neutral world of ongoing and considerable central bank influence on asset prices and the potential for periods of heightened volatility, it will be critical to get right not only the macro calls, but also the implementation of investment strategy in all PIMCO portfolios.



"Extraordinary policy actions by central banks have worked in part by pulling forward future returns."

All investments contain risk and may lose value. Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. **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. **Treasury Inflation-Protected Securities (TIPS)** are ILBs issued by the U.S. government. **Equities** may decline in value due to both real and perceived general market, economic and industry conditions. **Commodities** contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors. Investing in **foreign-denominated and/or -domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. **Currency rates** may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. **Absolute return portfolios** may not fully participate in strong positive market rallies. **Management risk** is the risk that the investment techniques and risk analyses applied by PIMCO will not produce the desired results, and that certain policies or developments may affect the investment techniques available to PIMCO in connection with managing the strategy. 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 investment professional prior to making an investment decision.

This material contains the opinions of the manager and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

PIMCO provides services only to qualified institutions and investors. This is not an offer to any person in any jurisdiction where unlawful or unauthorized. | **Pacific Investment Management Company LLC**, 650 Newport Center Drive, Newport Beach, CA 92660 is regulated by the United States Securities and Exchange Commission. | **PIMCO Investments LLC**, U.S. distributor, 1633 Broadway, New York, NY, 10019 is a company of PIMCO. | **PIMCO Europe Ltd** (Company No. 2604517), PIMCO Europe, Ltd Amsterdam Branch (Company No. 24319743), and PIMCO Europe Ltd - Italy (Company No. 07533910969) are authorised and regulated by the Financial Conduct Authority (25 The North Colonnade, Canary Wharf, London E14 5HS) in the U.K. The Amsterdam and Italy branches are additionally regulated by the AFM and CONSOB in accordance with Article 27 of the Italian Consolidated Financial Act, respectively. PIMCO Europe Ltd services and products are available only to professional clients as defined in the Financial Conduct Authority's Handbook and are not available to individual investors, who should not rely on this communication. | **PIMCO Deutschland GmbH** (Company No. 192083, Seidlstr. 24-24a, 80335 Munich, Germany) is authorised and regulated by the German Federal Financial Supervisory Authority (BaFin) (Marie-Curie-Str. 24-28, 60439 Frankfurt am Main) in Germany in accordance with Section 32 of the German Banking Act (KWG). The services and products provided by PIMCO Deutschland GmbH are available only to professional clients as defined in Section 31a para. 2 German Securities Trading Act (WpHG). They are not available to individual investors, who should not rely on this communication. | **PIMCO (Schweiz) GmbH** (registered in Switzerland, Company No. CH-020.4.038.582-2), Brandschenkestrasse 41, 8002 Zurich, Switzerland, Tel: + 41 44 512 49 10. The services and products provided by PIMCO Switzerland GmbH are not available to individual investors, who should not rely on this communication but contact their financial adviser. | **PIMCO Asia Pte Ltd** (501 Orchard Road #09-03, Wheelock Place, Singapore 238880, Registration No. 199804652K) is regulated by the Monetary Authority of Singapore as a holder of a capital markets services licence and an exempt financial adviser. The asset management services and investment products are not available to persons where provision of such services and products is unauthorised. | **PIMCO Asia Limited** (Suite 2201, 22nd Floor, Two International Finance Centre, No. 8 Finance Street, Central, Hong Kong) is licensed by the Securities and Futures Commission for Types 1, 4 and 9 regulated activities under the Securities and Futures Ordinance. The asset management services and investment products are not available to persons where provision of such services and products is unauthorised. | **PIMCO Australia Pty Ltd** ABN 54 084 280 508, AFSL 246862 (PIMCO Australia) offers products and services to both wholesale and retail clients as defined in the Corporations Act 2001 (limited to general financial product advice in the case of retail clients). This communication is provided for general information only without taking into account the objectives, financial situation or needs of any particular investors. | **PIMCO Japan Ltd** (Toranomon Towers Office 18F, 4-1-28, Toranomon, Minato-ku, Tokyo, Japan 105-0001) Financial Instruments Business Registration Number is Director of Kanto Local Finance Bureau (Financial Instruments Firm) No. 382. PIMCO Japan Ltd is a member of Japan Investment Advisers Association and The Investment Trusts Association, Japan. Investment management products and services offered by PIMCO Japan Ltd are offered only to persons within its respective jurisdiction, and are not available to persons where provision of such products or services is unauthorized. Valuations of assets will fluctuate based upon prices of securities and values of derivative transactions in the portfolio, market conditions, interest rates and credit risk, among others. Investments in foreign currency denominated assets will be affected by foreign exchange rates. There is no guarantee that the principal amount of the investment will be preserved, or that a certain return will be realized; the investment could suffer a loss. All profits and losses incur to the investor. The amounts, maximum amounts and calculation methodologies of each type of fee and expense and their total amounts will vary depending on the investment strategy, the status of investment performance, period of management and outstanding balance of assets and thus such fees and expenses cannot be set forth herein. | **PIMCO Canada Corp.** (199 Bay Street, Suite 2050, Commerce Court Station, P.O. Box 363, Toronto, ON, M5L 1G2) services and products may only be available in certain provinces or territories of Canada and only through dealers authorized for that purpose. | **PIMCO Latin America** Edifício Internacional Rio Praia do Flamengo, 154 1o andar, Rio de Janeiro – RJ Brasil 22210-906. | No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. PIMCO is a trademark or registered trademark of Allianz Asset Management of America L.P. in the United States and throughout the world. THE NEW NEUTRAL and YOUR GLOBAL INVESTMENT AUTHORITY are trademarks or registered trademarks of Pacific Investment Management Company LLC in the United States and throughout the world. ©2015, PIMCO.

Newport Beach Headquarters

650 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

Amsterdam

Hong Kong

London

Milan

Munich

New York

Rio de Janeiro

Singapore

Sydney

Tokyo

Toronto

Zurich

pimco.com