



Are we there yet?



**MARKETS SUMMIT**

Tuesday 16 February 2010

# Theme 1

## The big picture



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## The big picture

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# The big picture

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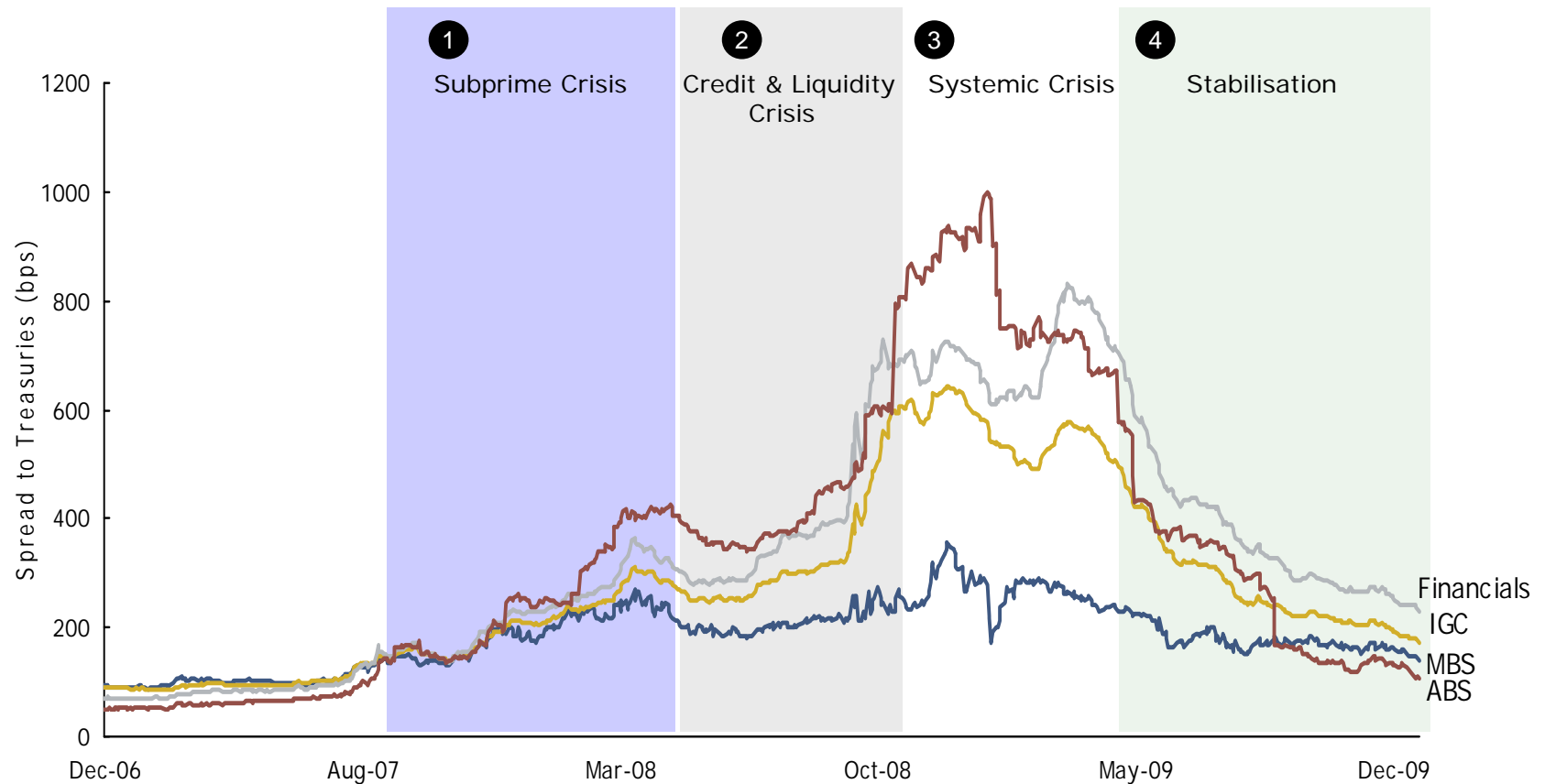


# Investing In The New Normal

February 2010

PortfolioConstruction Markets Summit 2010

# Re-Living the Past



SOURCE: Barclays Capital

Spreads for MBS, Investment Grade Corporate, ABS, and Financials are nominal spreads over Treasuries. MBS spreads are represented by the Barclays Capital Agency Fixed Rate MBS Index; Investment Grade Corporate spreads are represented by Barclays Capital U.S. Corporate Investment Grade Index; ABS spreads are represented by the Barclays Capital Asset-Backed Securities Index; Financials spreads are represented by the Barclays Capital Investment Grade: Financial Institutions Index.

<sup>1</sup> Bear Stearns hedge funds implode <sup>2</sup> Bear Stearns takeover

<sup>3</sup> Lehman Brothers bankruptcy <sup>4</sup> Federal reserve conducts stress tests of 19 largest financial institutions

As of December 31, 2009

# PIMCO positioning in 2009

- Overweight Duration in US, Europe, UK and Australia
- Overweight Agency MBS
- Overweight Investment Grade Credit, particularly financials
- Underweight lower quality credits



# What will be the key investment theme for 2010?

**2008:** Year of the financial collapse

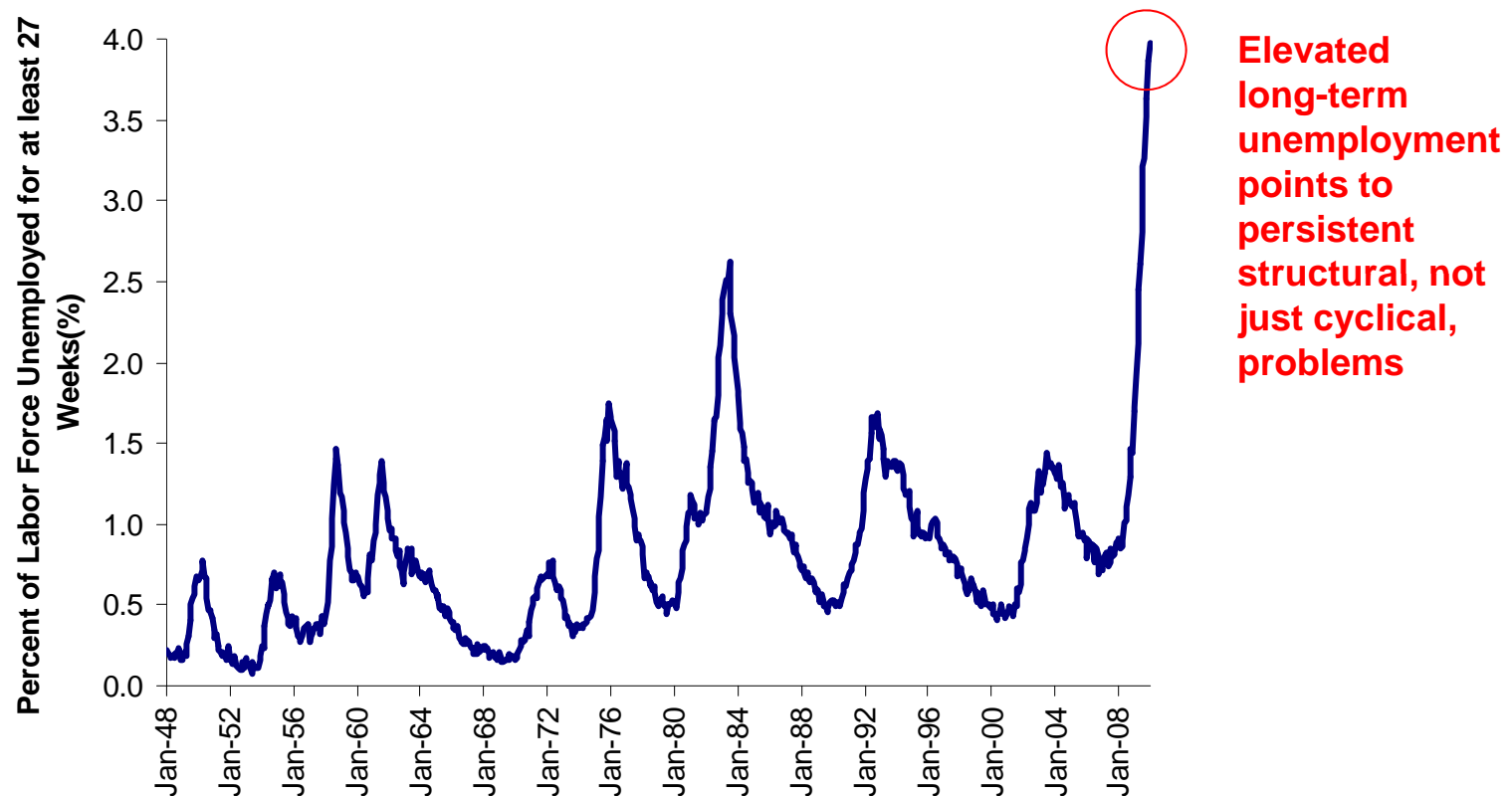
**2009:** Year of the power of government policy

**2010:** Year of the limits of government policy?



# Government policy brought us back from the brink...but we are far from Old Normal

Long-Term Unemployment Rate in the United States

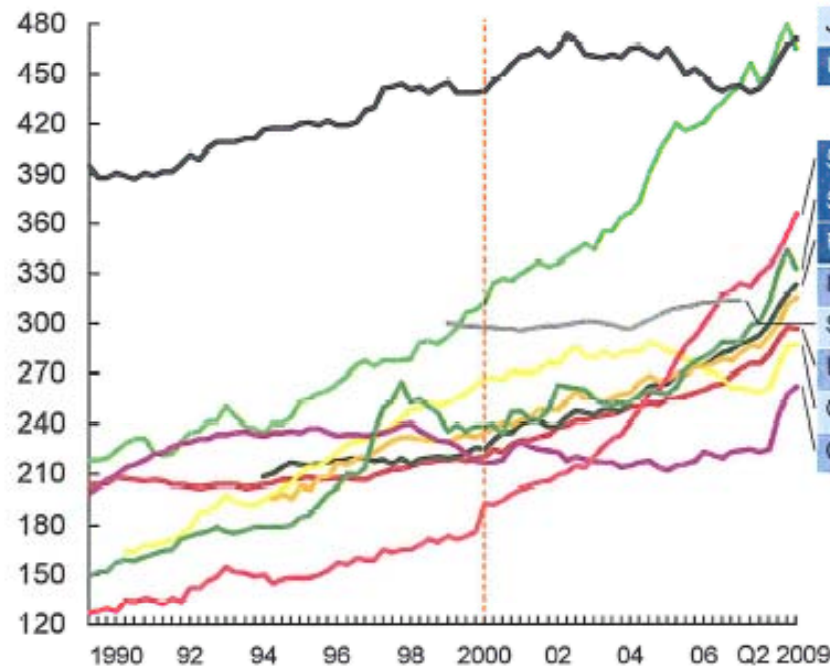


SOURCE: Bureau of Labor and Statistics

# Economic activity in recent years fuelled by extraordinary debt growth

## Debt grew in most mature economies

Domestic private and public sector debt<sup>1</sup> by country  
% of GDP



■ Rapid growth  
■ Moderate growth  
■ Slow/negative growth

CAGR<sup>2</sup>, %  
1990-00 2000-08 2000-08

Change, p.p.

Japan	1.2	0.5	19
UK <sup>3</sup>	3.3	5.2	157
Spain	4.1	7.4	150
S. Korea	4.3	4.2	93
France	1.2	3.9	83
Italy	2.9	3.1	64
Switzerland	N/A	0.8	17
US	0.6	3.5	70
Germany	5.6	0.3	7
Canada	0.3	1.5	28

1 "Debt" is defined as all credit market borrowing including loans and fixed-income securities.

2 Compound annual growth rate. Where data are unavailable, the longest possible period is used.

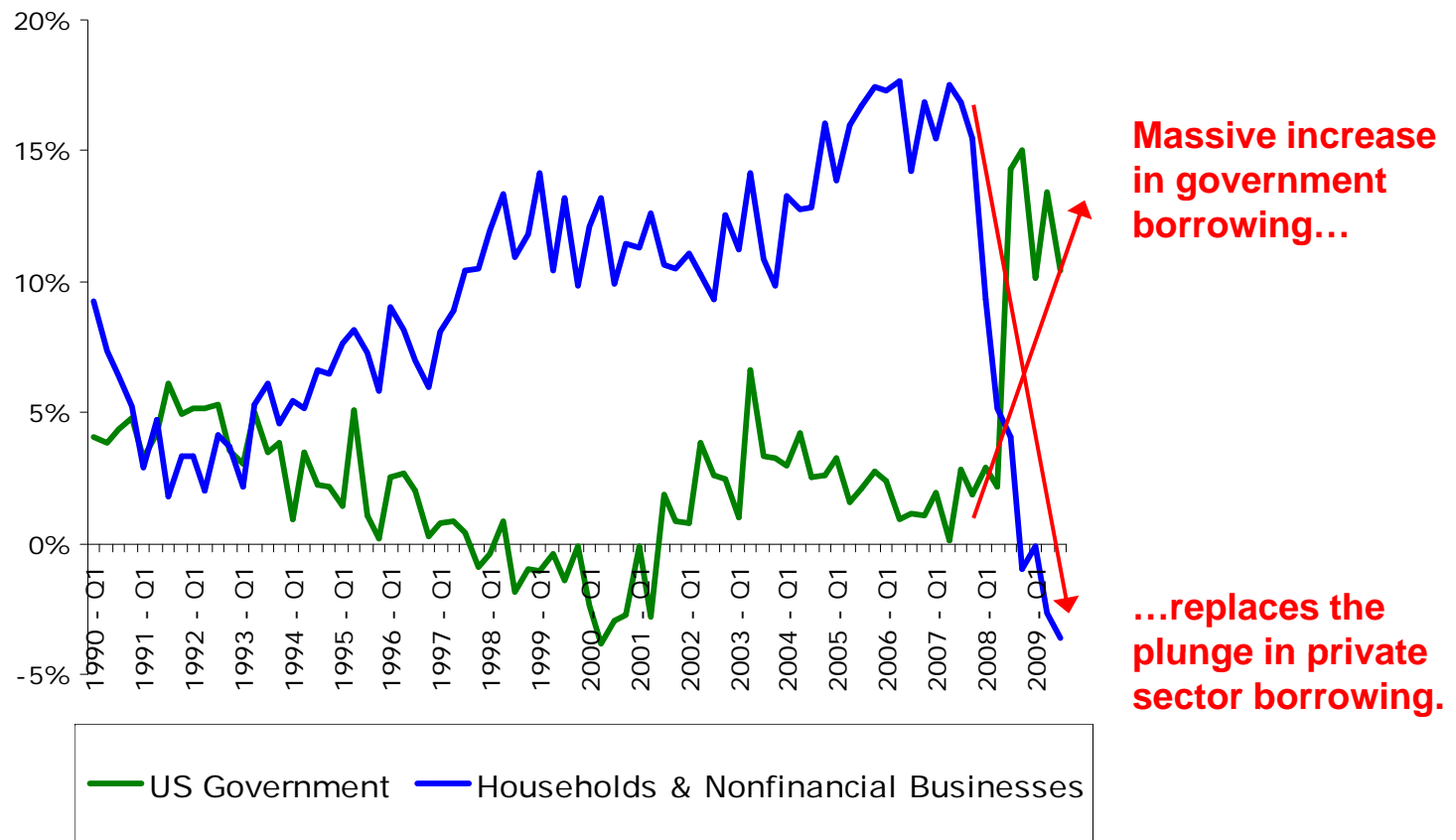
3 Even after removing foreign lending by UK banks, UK debt/GDP remains higher than every country except Japan.

SOURCE: Central banks; Haver Analytics; McKinsey Global Institute

SOURCE: McKinsey Global Institute

# Now, private sector de-leveraging cushioned by massive public re-leveraging

Net Borrowing in the United States (% of GDP)



SOURCE: US Federal Reserve Flow of Funds

# Rising public debt levels have put sovereign creditworthiness “in play”

5yr Sovereign CDS Spreads

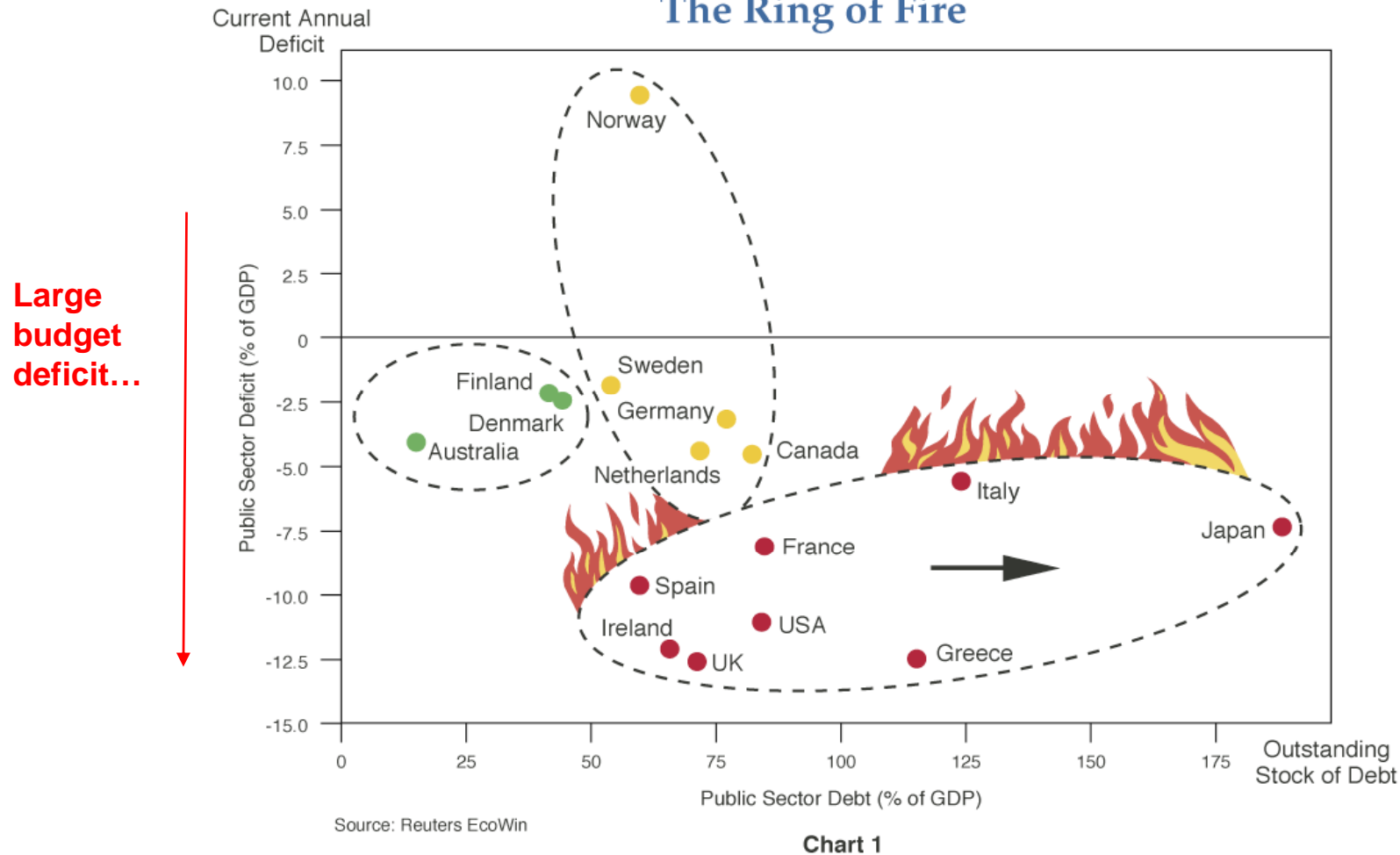


**Greece spreads imply  
25% probability of default  
within five years.**

SOURCE: Bloomberg

# Where are we now? Bond investors must think beyond traditional “interest rate risk”

## The Ring of Fire

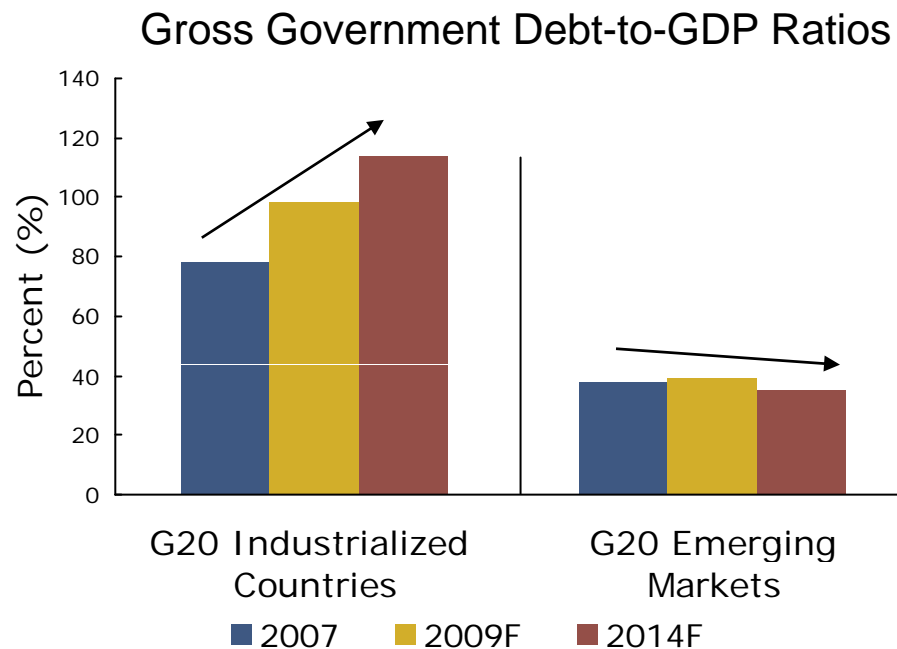


...combined  
with...

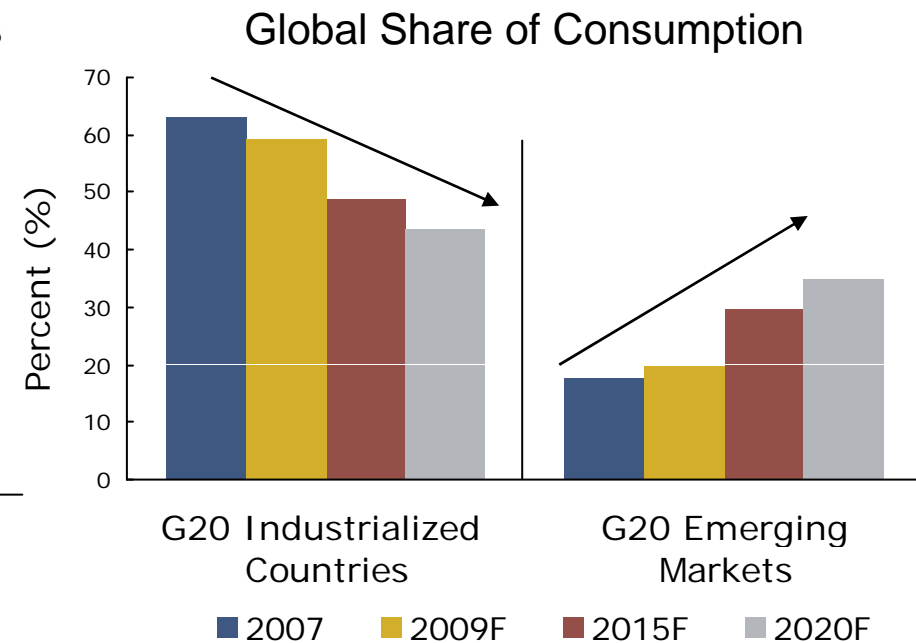
...Large debt stock

= Trouble

# Traditional patterns of global indebtedness are being turned around



Industrialized countries are expanding their indebtedness at an unprecedented pace ...

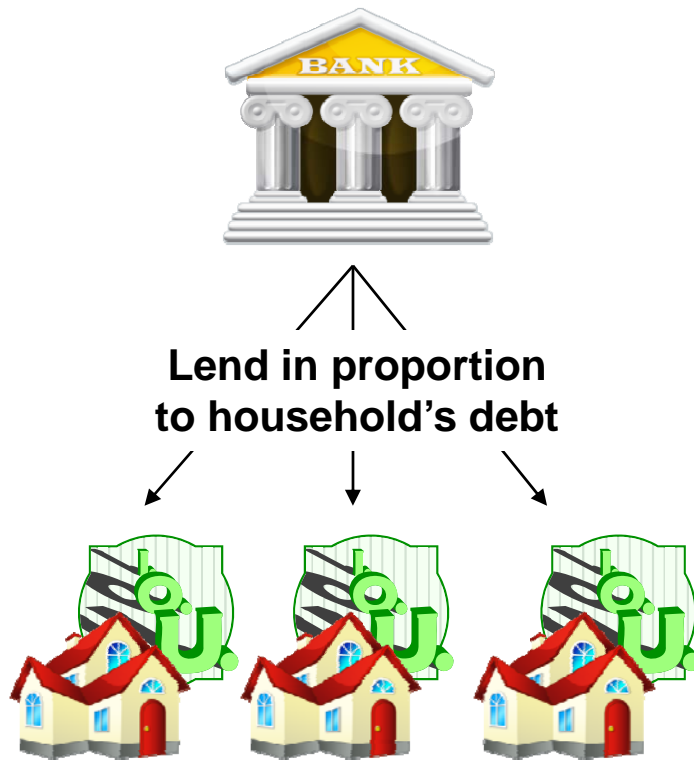


...even as their share of global economic activity declines precipitously.

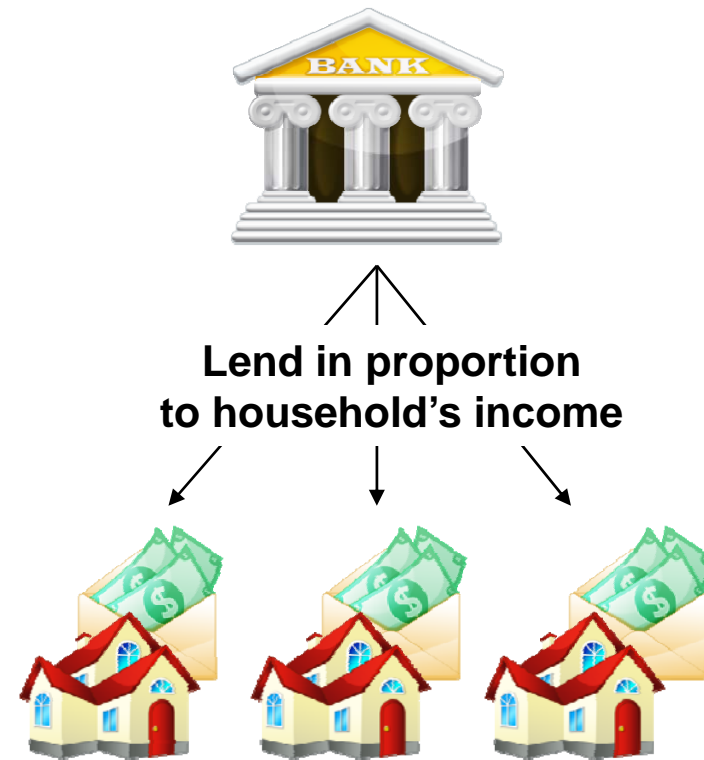


# Such transformations call for a new approach to bond indexing

## Debt-Weighted Approach



## Income-Weighted Approach



**Which makes more sense?**

# And renewed focus on tail events

- What are Tail Events?
  - Improbable events that cause significant portfolio effects

Statistically: Multi-standard deviation events

Colloquially: Hundred year floods

## Examples: Major Financial Crises since 1980

1982	Mexican default	1994-5	Mexican peso crisis
1987	Black Monday, Dow drops 22.6%	1997-8	Asian financial crisis
1989-91	United States S&L crisis	1998	Russian default and LTCM
1989-91	Latin American debt crises	2001-2	Argentine default, dot-com bust, Enron
1992-3	European Monetary System crisis	2007-9	Financial market meltdown



# December PIMCO Cyclical Economic Outlook

## Macroeconomic Forecast

- Economic recovery is underway, but growth unlikely to return to “Old Normal” levels
- Growth rates de-synchronised, differentiated by initial conditions and policy responses
- Inflation to remain low due to output gap (commodity/asset inflation possible)
- Potential for “fat tail” outcomes not insignificant

# Risks & Opportunities: The Known Unknowns

## Uncertainties

- Successful exit strategies: the hand off from temporary to sustainable growth drivers
- Balanced redistribution of wealth that does not undermine future growth
- Credible fiscal policies that limit public debt levels
- Key institutions can and will function outside short term political pressures

# Concluding Thoughts

- Limits of government policy in the New Normal
  - 2009 was year of recovery, 2010 revealing limits to fiscal/monetary tools
- Changing pattern of indebtedness is critical variable for bond investors
  - Fundamental challenge to traditional concepts of bond indexing & alpha generation
- Reliance on history cannot replace disciplined investment process
  - Models largely based on economic and market rationality, linearity and normal bell curves will fail
- Success will be achieved by those who are prepared, open and alert
  - Forward-looking
  - Focus on risk factors
  - Trim the tails

***The New Normal will call for increased adaptability and flexibility from each of us.***

# So What Should Investors Do?

- Ensure real diversity within portfolio
- Closely examine risks of traditional indexing
- Choose managers with proven forward looking skills



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