Riding a wave of accommodation - carefully

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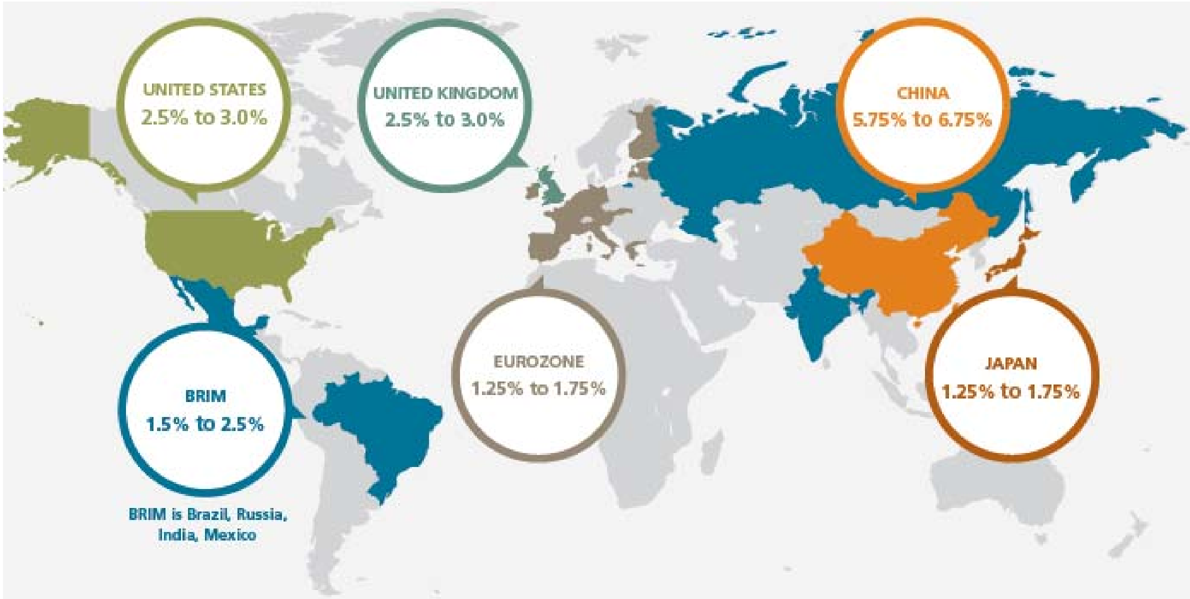
The key question for the global economy in 2015, as in each year since the great global recession of 2008–2009, can be posed as follows: Given that the world has since 2007 faced a chronic shortage of global aggregate demand relative to abundant and growing aggregate supply, have prices (can prices?) – of commodities, credit and currencies – adjusted by enough to generate a robust rise in global aggregate demand to close the gap with global supply?

THE BOTTOM LINE

- We see somewhat stronger global growth in 2015 than was recorded in 2014, but our views for global growth have not increased materially since our December 2014 forum.
- While we see somewhat faster growth in the eurozone, US and Japan in 2015, we have marked down our growth outlook for China.
- Lower oil prices and a wave of monetary policy accommodation in the rest of the world are a net positive for the global economy, but there are losers as well as winners, especially in some emerging market (EM) economies.
- Global inflation is projected to remain stable in the aggregate, but with many central banks easing monetary policy as an insurance policy against deflation.

Figure 1: Growth outlook for the next 12 months (GDP range)



Forecast	Real GDP		Headline inflation	
	Current*	Q1'15 – Q1'16	Current*	Q1'15 – Q1'16
United States	+2.4%	+2.5% to +3.0%	+1.6%	+1.5% to +2.0%
Eurozone	+0.9%	+1.25% to +1.75%	+0.2%	+0.75% to +1.25%
United Kingdom	+2.7%	+2.5% to +3.0%	+1.6%	+1.0% to +2.0%
Japan	-0.5%	+1.25% to +1.75%	+0.5%	+0.75% to +1.25%
China	+7.3%	+5.75% to +6.75%	+1.5%	+1.5% to +2.5%
BRIM**	+1.9%	+1.5% to +2.5%	+7.0%	+6.0% to +7.5%
World***	+2.5%	+2.5% to +3.0%	+1.7%	+1.75% to +2.25%

Source: Bloomberg, PIMCO calculations. * Current data for real GDP and inflation represent four quarters ending Q4 2014 or Q3 2014 if data not yet released. ** BRIM is Brazil, Russia, India, Mexico *** World is weighted average of countries listed in table above.

CONTEXT

As is the case at any PIMCO forum, we have three choices: to reaffirm our macroeconomic views laid out at the previous forum, to refine those views, or – if circumstances warrant – to replace those views. At our December 2014 forum, we concluded that, for the global economy, "A Rising Tide Lifts Most Boats." This outlook was based on the fall in oil prices that had occurred in the second half of 2014, our inference that most of that decline reflected positive supply factors and not negative demand factors, and our view that the European Central Bank (ECB) was likely in 2015 to announce a substantial quantitative easing program that would complement the QE program already in place in Japan.

Since the December forum, there have been several macroeconomic developments that could potentially impact the outlook for the global economy in a material way, and we discussed those at length. For example, since December a parade of more than 20 central banks from around the world – including all the major central banks save the Fed, which is still expected to commence hiking policy rates sometime in 2015 – have eased monetary conditions by slashing policy rates toward zero or even below zero (Figure 2). Moreover, the ECB in January announced a €1.1 trillion QE program that was much larger and more open-ended than the markets expected. Together these actions have produced a wave of global monetary policy accommodation – largely unforeseen in 2014 – that, in and of itself, should be supportive of growth and inflation expectations in those countries.

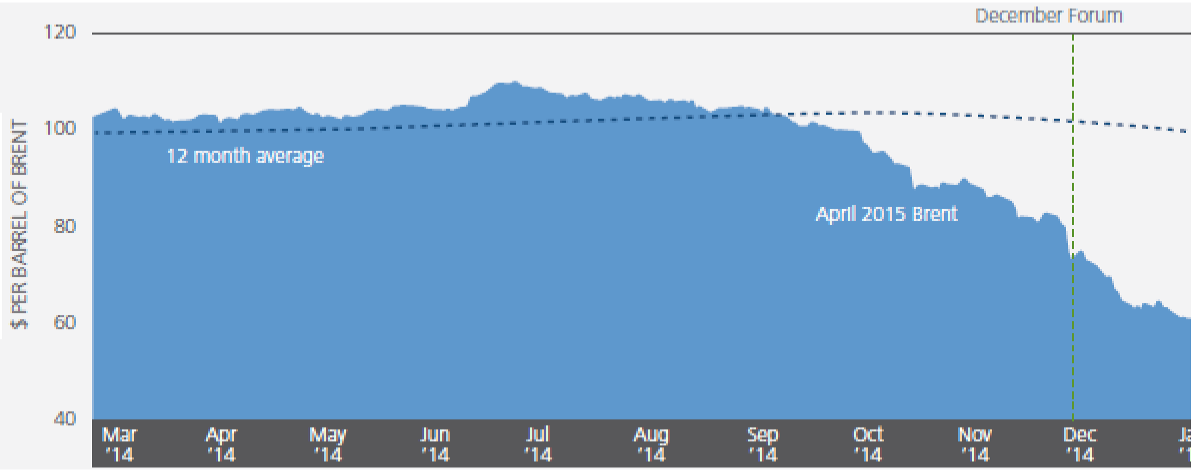
Figure 2: Central banks lower rates around the globe

CENTRAL BANK	DATE	ACTION
Central Bank of Iceland	10 Dec 14	Rate cut -50bp
Norges Bank (Norway)	11 Dec 14	Rate cut -25bp
Central Bank of Morocco	16 Dec 14	Rate cut -25bp
Central Bank of Uzbekistan	1 Jan 15	Rate cut -100bp
National Bank of Romania	7 Jan 15	Rate cut -25bp
Reserve Bank of India	15 Jan 15	Rate cut -25bp
Central Bank of Egypt	15 Jan 15	Rate cut -50bp
Central Reserve Bank of Peru	15 Jan 15	Rate cut -25bp
National Bank of Denmark	19 Jan 15	Rate cut -15bp
Central Bank of Turkey	20 Jan 15	Rate cut -50bp
Bank of Canada	21 Jan 15	Rate cut -25bp
National Bank of Denmark	22 Jan 15	Rate cut -15bp
European Central Bank	22 Jan 15	Announced QE of €60bn/month
State Bank of Pakistan	24 Jan 15	Rate cut -100bp
Monetary Authority of Singapore	28 Jan 15	Reduced slope of its policy band for the SGD NEER
Bank of Albania	28 Jan 15	Rate cut -25bp
National Bank of Denmark	29 Jan 15	Rate cut -15bp
Central Bank of Jordan	2 Feb 15	Rate cut -25bp
Reserve Bank of India	3 Feb 15	SLR cut -50bp
Reserve Bank of Australia	3 Feb 15	Rate cut -25bp
People's Bank of China	4 Feb 15	RRR cut -50bp
National Bank of Romania	4 Feb 15	Rate cut -25bp
National Bank of Denmark	5 Feb 15	Rate cut -25bp
Riksbank (Sweden)	12 Feb 15	Rate cut -10bps & launch of QE approx. $1.2B
Bank of Indonesia	17 Feb 15	Rate cut -25bp
Bank of Botswana	18 Feb 15	Rate -100bp
Bank of Israel	23 Feb 15	Rate cut -15bp
Central Bank of Turkey	24 Feb 15	Rate cut -25bp
People's Bank of China	28 Feb 15	Rate cut-25bp
Reserve Bank of India	4 Mar 15	Rate cut -25bp
National Bank of Poland	4 Mar 15	Rate cut -50bp

Source: Individual central banks as of dates indicated

Another material development since the December forum has been a further decline in oil prices relative to what was projected at the time (Figure 3). Oil prices are now $20 per barrel lower than they were in December and a full $40 lower than the average oil price in 2014. As we discussed at length in December, falling oil and, more broadly, commodity prices create both winners – in commodity importing countries – as well as losers – in the exporting countries. The net impact on global aggregate demand is expected to be positive since lower commodity prices are a transfer from commodity exporters with high saving rates (state oil companies, sovereign wealth funds) to consumers with lower saving rates.

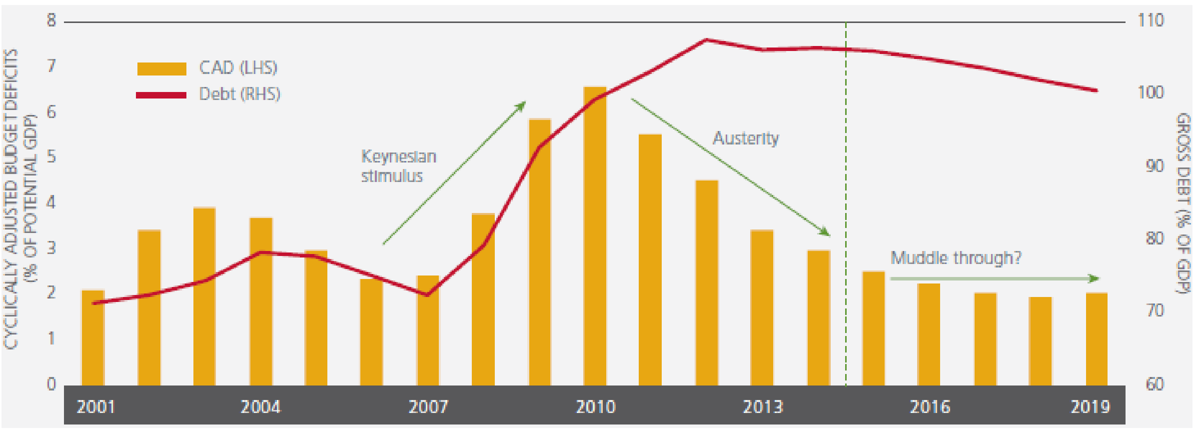
Figure 3: Oil price volatility continued after December



Source: Bloomberg

A third supportive development for global aggregate demand – exemplified by Prime Minister Shinzo Abe's decision in late 2014 to "postpone" a scheduled second VAT tax increase in Japan – is the accumulating evidence that over our cyclical horizon the impulse of global fiscal policy is likely to be neutral and not, as in recent years, negative and thus no longer subtracting from global aggregate demand (Figure 4).

Figure 4: Less fiscal austerity is good for global economy
Advanced economy cyclically adjusted budget deficits (CAD) as share of potential GDP)



Source: IMF Fiscal Outlook October 2014

RISKS

Given this context, discussion appropriately focused not only on what is a relatively positive baseline scenario for the global economy – one that calls for a stabilisation of global inflation and a modest rise in global growth that could surprise on the upside – but it also considered left tail risks to this baseline. These tail risks include (1) a negative, potentially disorderly market reaction – with macroeconomic consequences especially for EM countries – to what would be the first Fed rate hike in nine years, (2) the related risk that what is now a global currency "skirmish" descends into a currency war and (3) uncertainty about the exposure of the global economy and markets to geopolitical risk as well as the fragility of the economies that lose out from the end of the commodity supercycle.

ANALYSIS

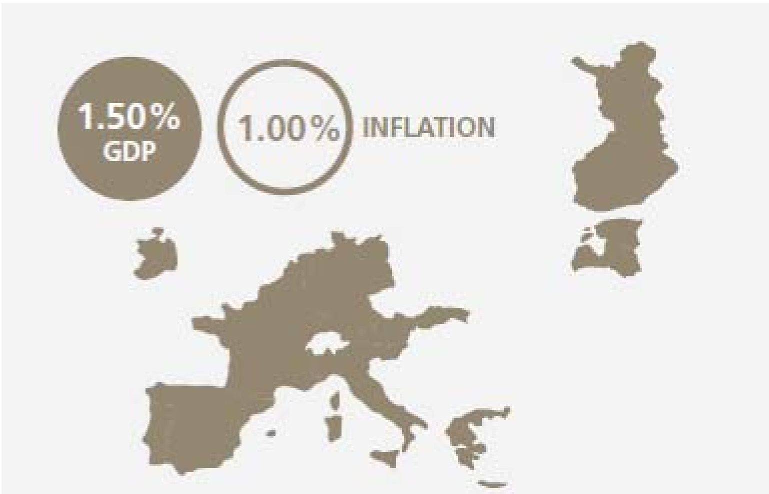
1. **United States**

Our baseline view remains that the US is on track for solid if not spectacular above-trend growth in the range of 2.5% to 3% (2.75% midpoint shown in graphic). This outlook reflects our expectation for robust consumption growth supported by a strengthening labor market and the boost to real income from low commodity prices.

However, against this positive outlook for consumption, we must weigh the potential negatives of sluggish export growth held back by the stronger dollar as well as the likelihood that capex spending will be held back by a slowdown in investment in the energy sector. While headline inflation may briefly turn negative due to the year-over-year decline in oil prices, we expect core inflation to bottom out near current levels and to rebound later in the year, and overall we expect inflation over the next four quarters to be close to the Fed's 2% target.

In terms of our Fed call, we believe that, for a variety of reasons to be discussed below, the Fed will likely commence a rate hike cycle later this year. That said, we see the Fed as operating with a New Neutral for the policy rate, and as a consequence, this hiking cycle will in important respects differ from previous Fed rate hike cycles both in terms of pace – slower – and in terms of the destination – lower.

2. Eurozone



As the blues song declares, "Been down so long it looks like up to me." We see low oil prices, a weak euro and ECB QE as a trifecta of tailwinds for the eurozone. And yet, when we add all this up, we can only credibly forecast growth of around 1.5% over the next 12 months.

The challenges are familiar: too much debt, too little structural reform and too many political challenges that weigh on confidence and animal spirits. We expect growth of around 2% in Spain and Germany and 1% or so in Italy and France. While modest, the pace of growth we envision is a significant improvement from the prior year, when eurozone GDP grew less than 1% on average. Weak demographics and poor productivity suggest that the economy will grow above potential, but only marginally so. Slack will therefore remain ample, which – together with the pressure to recover competitiveness in the periphery – will put a cap on wage growth and therefore inflation.

We think that inflation will move back up from around −0.5% currently to +1% or so in a year's time, but this will be due almost entirely to a normalization in energy price inflation, helped by a weaker euro. Core inflation is likely to remain fairly steady at just above 0.5%.

While improving, the outlook still points to a subdued macro picture, with an economy that grows only 2.5% or so in nominal terms over the next year. This pace of growth remains modest and challenging given the need for both public and private sectors to deleverage in several countries. In this environment, the ECB may well have to adjust its QE program higher. The challenges to European growth in the medium term mean that unstable debt dynamics remain an important secular risk.

3. Japan

Our views on Japan have changed little since December. Recall that the Bank of Japan (BOJ) surprise shock-and-awe announcement to double down on QE and Abe's decision to "postpone" the VAT increase were already factored in to our December forecast.

We still see growth of around 1.5% and core inflation running at about 1%. This baseline reflects the consensus view that consumption growth will be solid in the absence of the second VAT hike and that capital spending will be supported by easier financial conditions. Net exports are expected to improve to a large degree because of a decline in the oil import bill.

Our views of the BOJ have not changed. As demonstrated by the October surprise expansion of the existing ambitious QE program, the BOJ is all in and won't fail for lack of trying to reflate Japan's economy. BOJ Governor Haruhiko Kuroda's strong commitment to achieve 2% inflation in about two years appears unwavering. There is no change to our base case that the BOJ will continue its current QE2 program, with the possibility that additional easing may be forthcoming in the second half of 2015 if economic recovery falters. As in Europe, unstable debt dynamics remain a secular concern in the context of low nominal growth.

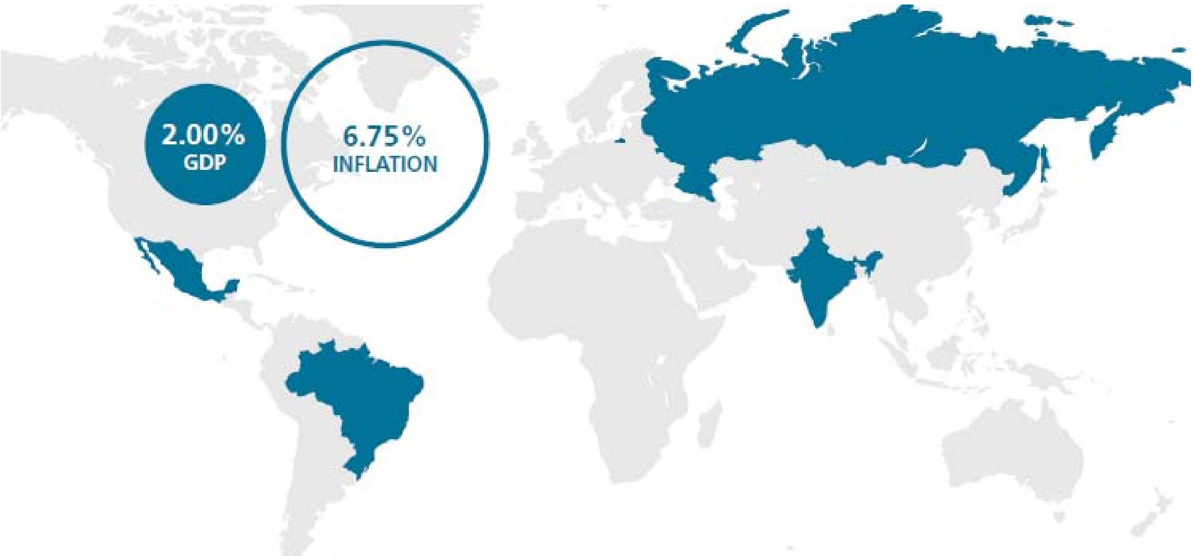
4. China

We have consistently held below-consensus views on Chinese growth prospects, and we continue to do so. Chinese officials themselves now refer to a "new normal" for the Chinese economy of "around" 7% growth, and we continue to think that GDP growth in China will fall short of that. For 2015, we see growth in the low 6% territory.

China is dealing with a property bust and deleveraging of the shadow banking system, and can no longer rely on low wages to undergird an endless export boom. The People's Bank of China has begun to ease rates and reserve requirements aiming for a soft landing, and we expect more easing to follow.

We discussed at some length the left tail risk that China enters a currency war and engineers (or blesses) a large competitive devaluation of the yuan. We concluded that scenario is unlikely because Chinese officials seem genuine in their desire to transition to a more domestic-consumption-based growth model and for the yuan to become a global currency and are obviously aware of the intense political backlash that would ensue

5. Emerging Markets (BRIM)



Note: BRIM is Brazil, Russia, India, Mexico

Emerging markets are facing a number of headwinds that are translating into slowing growth, negative output gaps and greater divergence in inflation rates.

Our baseline for BRIM (Brazil, Russia, India and Mexico) weighted average growth is around 2% as the commodity tailwind and Fed liquidity unwind, structural constraints start to bind and domestic/geopolitical headwinds come to the fore. This forecast is in line with consensus but with important country differences.

Russia and Brazil are projected to undergo recessions as the macro economy adjusts to lower commodities prices, weaker currencies and the fallout from both domestic and geopolitics. Meanwhile Mexico is expected to rebound modestly but with growth still below potential as the country adjusts its ambitious energy reforms to the new realities of a world with lower oil prices for the medium term.

We forecast BRIM inflation in the range of 6% to 7.5%, with our base case closer to 6% but with increasing risks to the upside as weaker currencies pass through to headline inflation. We also expect to see greater divergence across countries within the commodity exporting block – e.g., Russia and Brazil – facing rising price pressures, and the Asia block – primarily commodity importers like India – experiencing disinflation. Mexico sits somewhere in the middle with headline inflation well within the inflation target band of 3% +/− 1%.

In addition to these broad macro trends, BRIM economies are also experiencing a number of idiosyncratic themes. In Brazil, 2015 is likely to be another lost year with risks compounded by several negative shocks including the Petrobras crisis and energy rationing. This together with a more difficult political landscape makes the anchoring policies of Finance Minister Joaquim Levy even more critical. In Russia, the ongoing geopolitical crisis together with plummeting oil has increased the tail risks of credit events in the corporate space and runs on the banking sector driven by capital flight. Mexico and India, in contrast, are facing fewer domestic headwinds and instead are focused on progressing on ambitious structural reforms that should provide a boost to potential growth and the investment/ business climate in the medium term.

THE FED, AND EVERYONE ELSE

More than 20 central banks around the world have eased policy this year, while the Federal Reserve has clearly signaled its intention to embark on a monetary policy tightening cycle in 2015.

This cyclical divergence in policy is not surprising. The US is far advanced in terms of its post-crisis rehabilitation compared with other developed countries and is a winner from the decline in energy prices compared with the overall very mixed impact on emerging market countries. In terms of economic fundamentals, the narrowing in the gap between the U.S. and the rest of the world is fragile for the very reason that it derives significantly from the ongoing extraordinary monetary policy support outside the US and the ongoing shortfall in global aggregate demand compared with the world's supply potential.

The outlook for the Federal Reserve was of key importance in our discussions, in debate with Dr Bernanke and during three days of strategy discussions immediately following the forum. The impending Fed rate hike cycle has the potential to have large market impacts, including a significant rise in volatility as witnessed during the 2013 "taper tantrum" after the Fed signaled the beginning of the end of its QE program. Yet, the tightening cycle ahead has different characteristics from a typical "late cycle" attempt to slow growth and bear down on inflation, as the fact is that the Fed is likely to embark on its first hike at a time when the current headline inflation reading will be close to zero.

The Fed has no need to try to slow economic growth sharply, and we expect Janet Yellen and her colleagues to place a high premium on very clear messaging and data dependency. We expect the Fed to start tightening policy in June, September or December, and to proceed at a fairly slow pace, with a hike every other meeting, at least at the outset. By removing the language on patience at its March meeting, the Fed has given itself the flexibility to act without pre-committing on the date.

Our New Neutral framework suggests that the real neutral rate for the Fed, consistent with growth at close to trend and inflation at close to target, is likely to be in a range of 0%-0.5%. Assuming inflation close to target, in line with our cyclical forecast, for the next few years, we think the Fed is likely to move its target federal funds rate to 2% to 2.5% over the next couple of years. Fed guidance also suggests that the Federal Open Market Committee will either stop or reduce the reinvestment of coupon payments on the QE bonds it holds on its balance sheet after the first couple of rate hikes.

By definition, the concept of the neutral rate is time-varying, together with the growth and inflation dynamics that underlie it. The 2% to 2.5% nominal rate is a reasonable medium-term expectation, but the Fed will do less than that if there are downside data surprises and indeed an outsized market reaction to its tightening, and more over time if inflation were to surprise on the upside.

While it is unlikely that policy easing outside the US will stop the Fed from moving – indeed, the ECB and the BOJ are providing support for risk assets at the same time that the Fed is likely to be tightening – weaker growth outside the US and the strength of the US dollar are factors reinforcing the expectation for a low real neutral rate for the Fed.

The scale of the Fed’s challenge should not be underestimated. Dr Bernanke, in his contributions to the forum debate, stressed that there is no peacetime precedent of a central bank successfully tightening policy and sustainably exiting the zero bound. The Fed and therefore market participants are entering uncharted waters. The baseline must be for a rise in market volatility with the risk case a significant shock to stability.

INVESTMENT IMPLICATIONS

Expectations for a low New Neutral policy rate compared with historical experience remain an important anchor for global asset markets. But a challenge in terms of investment strategy is that this expectation is fully priced into global fixed income and equity markets.

In the US and in some other countries there is a strong case that markets need to price in more risk premium compared with a low-for-long baseline. At the current level of yields, we continue to favor an underweight duration position in U.S. rates and expect that solidifying expectations for the Fed rate hike cycle together with the stabilisation in oil prices forecast by our commodity specialists will provide support to this valuation-driven investment thesis over the coming months.

Related to this need for greater risk premium, we will be cautious on exposures at the front end of the US curve – a tactical position that stands in contrast to our secular and structural bias in favor of curve steepening positions. We will continue to monitor very closely market positioning and in particular global investment flows driven by emergency policy settings elsewhere.

In Europe, similarly we see little long-term value in core government yields at current levels, but at the same time we are respectful of the technical forces unleashed on the flow of funds by the ECB's planned €60 billion per month of asset purchases in terms of both core duration and curve positions. We expect the technicals to overwhelm the fundamentals at least in the near term. Core duration levels, which look too low, could be driven yet lower.

European peripheral risk, notably the larger markets of Italy and Spain, remain attractive versus German bunds on a spread basis – with the potential for ECB purchases to drive spreads significantly tighter – and as a liquid source of sovereign credit risk.

The potential for a Fed-driven rise in volatility argues for keeping some dry powder in portfolios in order to leave room to add positions at more attractive valuations. In general, options markets have priced in the prospect of higher realized volatility to a very reasonable extent, such that volatility levels look reasonably attractive at the same time that corporate credit markets have continued to tighten.

1. Credit

Corporate credit fundamentals remain strong, and our overall macro forecasts are supportive for global credit, but there is a case for greater tactical caution given the uncertainties around the impact of the Fed tightening cycle.

At the sector level, we continue to see good opportunities in European bank capital, a sector that is likely to benefit from the support that is provided by ECB QE, and debt holders over time will benefit from the ongoing reregulation and pressure for capital raising that is a central part of our New Normal secular outlook.

More generally in credit markets, at a time when market betas look fair rather than cheap, we will continue to focus our efforts on bottom-up security selection to generate alpha, based upon the analysis and insights provided by our large, global team of credit analysts.

2. Inflation-linked bonds

While inflation is currently at low levels and likely to fall further, we expect normalisation over the cyclical horizon in the US and at the margin some success from the ECB in its campaign for European reflation. Our cyclical forecast in the US is for inflation close to the Fed's 2% target for core PCE, and over time we see value in TIPS (Treasury Inflation-Protected Securities) given the potential for inflation break-evens to reprice in line with the core PCE at close to 2%, which equate to break-evens at 2.3% on the CPI measure.

3. MBS

Agency mortgage-backed securities do not look attractive based upon valuation and the prospect of the Fed tapering or stopping its reinvestment of coupons paid on its MBS portfolio. In contrast, non-agency mortgages continue to offer potential value, and while the valuation gap versus other credit-like assets has narrowed, non-agencies offer seniority in the capital structure, an equity cushion that has been rebuilt in recent years and overall resiliency in terms of a range of reasonable economic and housing market scenarios.

4. Emerging markets

Emerging markets are likely to remain under pressure, reflecting the combination of the prospective Fed rate hiking cycle, the US dollar's strength, the lower level of commodity prices and a range of idiosyncratic country risks in what is a highly differentiated asset class. We will be cautious overall in our EM positioning, but will look for select opportunities across countries and across markets.

5. Currencies

Finally, returning to the theme of cyclical divergence on both fundamentals and on policy – as well as the potential for increased corporate hedging – we will continue to favor overweights to the US dollar versus the euro, the yen and select other currencies, a position that has generally served our clients well over the past year and which we believe will continue to be a source of positive returns over the cyclical horizon.

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. Treasury Inflation- Protected Securities (TIPS) are ILBs issued by the U.S. government. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

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