



MARKET OUTLOOK

Q3 2008

PIMCO SECULAR ECONOMIC OUTLOOK FOR 2008

PIMCO believes that secular economic, social and political trends exert the most powerful and sustained influences on bond markets. We define "secular" as the next three to five years. Our secular outlook guides the way we structure portfolios in terms of duration, yield curve positioning, sector exposure, credit quality and other risk measures. The following are the key themes in PIMCO's Secular Outlook:

- **Emerging Economies to Lead Global Growth** - Global growth will remain robust despite a cyclical downturn in the U.S. and other developed economies. Growth will be driven to a greater extent by emerging markets that are in the midst of a breakout development phase. The global economy is evolving into a multi-polar growth world where countries such as China emphasise more balanced development paths that include enhanced consumption, market-based systems and more flexible exchange rates.
- **Upward Trend in Inflation** - Inflation pressures will spring from several sources. These include: the spillover of global demand into commodities; gradually rising wages as well as policy shifts toward greater employment and social spending in developing economies; and loose U.S. monetary policy that tends to export inflation, especially to emerging economies that align their currencies with the U.S. dollar.
- **Lower Corporate Profits** - Profits are likely to decline from current high levels, both overall and relative to labor, as low wages in emerging markets rise. In addition, as the financial sector works its way through the subprime crisis it will have to raise more capital, reduce leverage and tighten lending standards. While such measures will promote stability over the long run, they will have a depressing effect on profitability over the next several years for financial companies and the corporate sector overall.

- **Realignment of the Global Financial System** - In developed economies, regulatory changes and balance sheet management will drive realignment. Now that the Federal Reserve has opened its discount window to investment banks, these institutions are likely to face greater capital requirements and oversight. The financial sector in the developed world will be driven toward a business model with lower leverage and lower risk. Realignment will take a different form in emerging markets. Local capital markets in emerging economies will continue to develop as consumers and businesses demand a wider range of financial services. The influence of sovereign wealth funds will grow as they diversify risk profiles of their portfolios.

PIMCO's Cyclical Economic Outlook

While the Secular Outlook is the foundation for PIMCO's portfolio strategies, we refine this outlook to account for expected developments over a cyclical, or 6 to 12-month time frame. Major aspects of our cyclical view are:

- **Fed Unlikely to Tighten in Near Term** - The financial system is highly sensitive to shifts in monetary and fiscal policy amid constrained balance sheet liquidity and asset write-downs that continue to erode banks' capital. There is also growing evidence that fallout from the subprime debacle has now spread to the U.S. regional banking sector. In this environment, the Fed is unlikely to have the latitude to raise short-term interest rates over the next several months despite growing inflation pressure.
- **RBA to Remain on Hold** - The RBA remains on hold, appearing to equally weigh inflation pressures versus the combination of global financial system instability and peaking domestic economic growth.
- **Heightened Volatility for Investment Strategies** - PIMCO expects that the vulnerability of the global financial system to policy mistakes will make risk exposures in investment portfolios more volatile. On the positive side, however, this volatility is also likely to create more opportunities for astute investors to add value.

...PIMCO will retain an overweight to mortgage-backed bonds, especially those arranged by the major mortgage agencies, to capture yield premiums well above historical averages.

Investment Implications of Secular and Cyclical Outlook

The following is a summary of broad investment themes that flow from PIMCO's Secular Outlook, as well as descriptions of how PIMCO expects to express these themes.

- **Limit Interest Rate Risk** - PIMCO will look to reduce exposure to interest rates in the U.S. and elsewhere in the world, especially on the longer end of yield curves. Longer maturity rates are vulnerable to inflation risk and, in the case of the U.S., the need to finance higher expected fiscal deficits and attract investors already heavily exposed to Treasuries. In the U.S., we will target duration below the benchmark. With the U.S. yield curve likely to remain steep, we will retain our focus on relatively short maturities, a strategy that offers the potential for gains as bonds "roll down", or mature along the steep yield curve over time.

Outside the U.S., PIMCO will retain exposure to the front end of the U.K. yield curve, though at reduced levels. The Bank of England faces the same constraints with respect to raising rates as does the Fed, which means that U.K. short rates are unlikely to rise as much as markets expect.

Given the inverted yield curve, we will overweight Australian duration with an emphasis on short-dated maturities, where yields are higher and there is potential price appreciation on the back of slower growth. PIMCO will continue to focus on Australian swaps over Governments and Semi Governments as these instruments offer additional yield.

- **Own High Quality Assets With Attractive Yields** - Debt reduction and balance sheet realignment, and the resulting dearth of liquidity, have contributed to a dramatic widening in risk premiums across a variety of fixed income assets. PIMCO will be discriminating as it pursues these opportunities. We believe that the best risk-adjusted returns will be found in the senior part of the economy's capital structure. These securities include top quality corporates, mortgages and other asset-backed bonds where valuations have cheapened less for reasons of credit weakness than because of system-wide liquidity constraints.

For example, PIMCO will retain an overweight to mortgage-backed bonds, especially those arranged by the major mortgage agencies, to capture yield premiums well above historical averages.

- **Look for Value in Financials** - Realignment of the financial sector could create compelling opportunities for investors. Regulators will look to remove risks of institutional failure from the banking system. The cost of this regulatory reaction will be a lower return on capital that will likely tilt relative value in the direction of bondholders and away from stocks of financial companies. While PIMCO will retain an overall underweight to the corporate sector, we will continue to emphasise select, high grade corporates where the credit crisis has produced attractive valuations, including bonds of banking and finance companies. Some of these financial institutions may well be too big to fail, thus putting them under the "umbrella" of the Fed.

- **Position for Renewed U.S. Dollar Weakness** - The U.S. dollar's decline is not over, but the currencies that carry the brunt of the appreciation versus the dollar will change. The gainers will no longer be dominated by countries with floating currencies, such as the euro, pound and yen. PIMCO will take modest positions that benefit when these currencies lose value versus the U.S. dollar. We will emphasise currencies of emerging market countries (such as China and elsewhere in Asia) with relatively inflexible currency regimes that will be forced to let their currencies rise against the U.S. dollar to combat inflation.



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