



MARKET OUTLOOK

Q2 2009

SEVERE GLOBAL RECESSION LIKELY TO CONTINUE THROUGH 2009

PIMCO expects the severe global recession to continue throughout 2009 despite fiscal and monetary stimulus being applied by policymakers. The recession should produce disinflation and may result in deflation in some economies for a time. While China will suffer less than developed economies, it will not be able to decouple from the rest of the world. It is unclear how much traction global policy initiatives will gain by 2010, but when recovery comes it is unlikely to be very robust, resembling an L-shape more than a U or V. Interest rates are likely to remain low worldwide, with the 10-year US Treasury yield ranging between two to three percent over the next year.

- **Collision of Three Realities** – The most important dynamic in the global economy today is the collision of three realities: economic, financial and political. A sense of uncertainty pervades financial markets because the results of such a collision are very difficult to forecast.
- **Economic Reality** – For the first time in the post-World War II period, the world cannot rely on the US consumer to be the spender of last resort. Exactly the opposite is occurring as overstretched US consumers ramp up their saving and try to pay down debt.
- **Financial Reality** – Deleveraging by banks and other financial institutions has produced global asset price deflation and dampened risk appetites. Massive fiscal stimulus and expansion of the US government's balance sheet would be needed to offset the deflationary impact of these economic and financial challenges.
- **Political Reality** – Unfortunately, political reality will intervene. In the US, politicians and the public lack the will to support fiscal expansion and aid to the financial sector that is large enough to address the problems.
- **Public/Private Burden Sharing** – This becomes the most likely option for dealing with a weak consumer sector and troubled banks. Examples would be proposals to modify terms of home mortgages in bankruptcy proceedings or the preferential treatment of non-US sovereign

holders of bank preferred stock. PIMCO expects that this burden sharing, which can involve arbitrary changes to contracts, could fuel uncertainty that will lead to disengagement by market participants. The result would be less liquidity and further asset price deflation, and hence lower real economic activity.

- **Uncertainty Outside the US** – Economic stimulus in Europe will be complicated by the absence of political union to complement monetary union. There is no central fiscal authority to redistribute resources from strong countries such as Germany to those on the periphery, such as Greece and Spain, which are suffering more from the recession. A more vigorous policy response is likely in the UK, which suffers from financial imbalances similar to those of peripheral Eurozone countries but has the advantage of more exchange rate and monetary policy flexibility. In Japan, the evaporation of external demand and a yen rally have caused the recession to deepen at a rapid pace. No recovery is in sight until global growth returns.
- **Slower Growth in Emerging Markets** – Emerging economies will enter a period of lower growth in which their economic activity is expected to be more closely correlated with that of the US. Planned fiscal and monetary stimulus should cushion the blow but is unlikely to be entirely sufficient in filling the gap created by falling exports and weaker domestic demand.

Retain High Quality Emphasis Amid Policy Uncertainty

PIMCO plans to retain an emphasis on assets at the top of the economy's capital structure as uncertainty arising from potential burden sharing between the public and private sectors clouds the investment horizon. Demands for private investors to share the burden of recapitalising the banking system and stimulating the economy are likely to fall most heavily on riskier asset classes in more subordinated positions. Now is a time for caution with respect to those assets.

With respect to emerging markets, we may look to add attractively priced high quality credits such as Brazil and Mexico to our modest EM allocation as the credit markets begin to recover.

The following is a summary of PIMCO's major strategies:

- **Interest Rate Exposures** – We plan to target a slight overweight to duration in the US and, where permitted, in Europe and the UK. Interest rates are unlikely to rise and could trend downward from current levels near the high end of our forecasted ranges while the global economy remains weak. Monetary easing also makes it unlikely that short rates will rise relative to long rates anytime soon, so we will likely retain yield curve steepening strategies.

- **Sector Exposures** – There are a number of opportunities to add value among attractively priced high quality assets. Liquidity injections by the Federal Reserve and government programs such as the Term Asset-Backed Securities Loan Facility, or TALF, are expected to help bolster these markets. PIMCO therefore plans to retain an overweight to high quality Agency mortgage pass-throughs, which currently offer attractive yields and should benefit from continued government policy support. Also, we will likely continue to own upper tier non-Agency mortgages and consumer asset-backed bonds, which should get a boost from TALF.

In credit, PIMCO will focus on non-cyclical defensive industries that have the potential to outperform in an environment of weak growth, such as telecom, healthcare, pharmaceuticals and cable. Regulated industries with high quality infrastructure assets that are critical to the economy, such as utilities and pipelines, also offer attractive opportunities. A lack of clarity in the government's policy toward bank recapitalisation will result in a cautious stance on financial bonds; we do not expect to add exposure to mostly senior positions in these credits.

- **Tactical Allocations** – Other assets that are relatively senior in the capital structure, such as Treasury Inflation Protected Securities (TIPS) and municipal bonds, also represent prudent allocations. TIPS offer an explicit government guarantee and should benefit from increased investor interest in inflation protection. High quality municipal bonds, especially longer maturities, currently offer historically attractive yields compared to taxable bonds.

PIMCO is not ready to venture into high yield corporate bonds at this point in the economic cycle. While these bonds are trading at what seem to be compelling valuations, their credit premiums could widen further as defaults surge amid the worldwide economic slowdown. With respect to emerging markets, we may look to add attractively priced high quality credits such as Brazil and Mexico to our modest EM allocation as the credit markets begin to recover.

- **Currency Exposure** – PIMCO does not have strong conviction about the US dollar over the cyclical horizon, so there will be minimal currency exposure in portfolios.



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