PIMCO’s Forums: 
Reading the Road

PIMCO’s economic forums help provide a framework for how we position our clients’ portfolios. Our annual Secular Forum looks over a three-to-five-year horizon. Three times a year, we also hold Cyclical Forums to test and refine our macroeconomic thinking against current facts on the ground, reconciling likely events in the next six to twelve months with our longer-term forecast.

These cyclical “check-ins” are key to our process. If our secular outlook tells us which direction the freeway is headed, then our cyclical outlook reads more immediate conditions so we know which lane to drive in, how fast to go and what the drivers around us are doing.

Process

PIMCO’s time-tested process combines our top-down global outlook with extensive bottom-up security analysis and risk management capabilities.

**ECONOMIC FORUMS**

Four times a year (at the annual Secular Forum and three Cyclical Forums), our investment professionals around the world gather to identify the trends that will drive the global economy and markets. This macroeconomic outlook informs all PIMCO portfolios.

**INVESTMENT COMMITTEE**

The Investment Committee (IC) meets two hours each day to distill our outlook and current events into specific investment themes and risk factor targets.

**PORTFOLIO MANAGERS**

Portfolio managers are responsible for day-to-day strategy execution, leveraging our scores of sector and regional specialists.
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PIMCO expects the world’s major economies to continue converging while central bank policies diverge. Over the next 12 months, our baseline view is global growth of 2.25%–2.75% and global headline inflation of 1.75%–2.25%.

The Federal Reserve (Fed) will not be the only central bank hiking this year; Mexico, Brazil and South Africa are expected to raise rates, and the Bank of England could start tightening monetary policy as well. That said, most other central banks around the world, and all the other major ones – European Central Bank, Bank of Japan, People’s Bank of China – will likely maintain accommodation or further easing in 2016.

While central bank policies are diverging, we expect the world’s major global economies to continue to converge. The U.S. recovery will remain on a fairly stable path, and growth in Europe and Japan will increase modestly. China will continue to deal with the challenges of slower growth while BRIM (Brazil, Russia, India and Mexico) economies should improve modestly, though this collective average may mask meaningful divergences within the group. The net result will be a sideways trajectory for the global economy and numerous implications for investors.

*Putting Markets in Perspective* is designed to provide some direction for today’s complex marketplace. It presents, in a concise format, PIMCO’s latest thinking on key themes driving economies and markets, practical applications for investors and specific solutions to consider.

For additional *Putting Markets in Perspective* resources, visit [global.pimco.com/puttingmarketsinperspective](http://global.pimco.com/puttingmarketsinperspective)
PIMCO expects the global economy to continue its modest expansion and global inflation to grow faster.

**WHAT THESE CHARTS SHOW**

PIMCO believes the global economic expansion will continue. One reason is the output gap, which is shown in the first chart. Output gap is the difference between what the economy actually produces (GDP) and what it could produce at full capacity. A negative gap means that the economy is producing less than it would at full capacity, suggesting it may still have room to grow; a positive gap means the economy is producing more than its full potential, raising concerns of overheating and a recession. After a severe drop in 2008, steady growth in output has narrowed the gap for the G7 countries (blue line), but it is still negative at -1.2%. Typically, central banks will institute or maintain policies that support economic growth when the output gap is negative. PIMCO expects central banks to do just that, and believes these policies will enable the global economy to continue its growth trend, increasing to 2.25%–2.75% in 2016 (second chart). PIMCO is also forecasting an increase in global inflation, particularly core inflation, with the potential for faster wage growth in the U.S. as a key driving force.

**WHAT IT MEANS FOR INVESTORS**

Investors will face more challenging conditions for generating attractive levels of returns. Consider a broader investment universe and more tactical shifts across and within an allocation strategy.

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**ECONOMY: GLOBAL**

**PIMCO expects continued moderate growth**

Forecasting global GDP of 2.25%–2.75% and global inflation of 1.75%–2.25%

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Source: PIMCO, Bloomberg. Global economy defined as G7 countries: Canada, France, Germany, United Kingdom, Italy, Japan and United States. Data as of 31 December 2015.

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Source: PIMCO. Forecast is for four quarters ending Q4 2016. World is a weighted average sum of countries listed in chart above. BRIM is Brazil, Russia, India and Mexico. Charts are provided for illustrative purposes and are not indicative of the past or future performance of any PIMCO product.
PIMCO’s 2016 baseline view for the U.S. is continued growth of 2.0%–2.5% and inflation of 1.5%–2.0%.

WHAT THESE CHARTS SHOW
Given that the current U.S. economic expansion started in June 2009, some investors have begun to wonder if it has run its course. The first chart shows this expansion (yellow bar) is indeed long by historical standards, but expansions don’t generally die of old age: something kills them. Some of the usual suspects in these deaths include: a spike in oil prices, overinvestment, overconsumption, and, in many cases, interest rate hikes. The Fed’s recently launched tightening cycle is probably not a threat, however. Unlike during previous cycles, this time around the Fed is looking to normalize rates and not to slow economic growth. The second chart shows how this unusual objective has influenced the tightening strategy. The dotted blue line shows the Fed’s expectations for the cycle (based on Fed member predictions) and the solid blue line shows the market’s expectations. Both call for a slower, more moderate increase in rates than in previous cycles (shown in green, yellow and red). This more tempered approach is intended to raise rates off of zero without disrupting economic growth.

INVESTMENT IMPLICATIONS
Investors will want to avoid the temptation to be overly defensive out of fear that the expansion is ending. Instead, opt for a diversified, actively managed portfolio that can benefit from a moderately improving economy and take advantage of opportunities that result from changing economic and market conditions.

ECONOMY: U.S.
The ECB’s QE program is continuing to have a positive impact on the economy, which PIMCO expects to grow 1.25%–1.75% in 2016.

WHAT THESE CHARTS SHOW
The struggling eurozone economy got a welcome boost a year ago in January when the European Central Bank (ECB) initiated a quantitative easing program (QE). The magnitude of monetary expansion exceeded expectations, as seen in the dotted lines of the first chart. Notice that the euro and the German bund yield (light blue and dark blue dotted lines respectively) had both been declining in advance of the announcement, suggesting the market expected easing. Both continued on that downward trend after the announcement, indicating that the ECB had exceeded expectations. The ECB once again stepped up to offer support at the end of 2015 but this time the size of the stimulus disappointed the markets, as seen by the rally in the euro and bund yields (solid lines). In PIMCO’s view, the December response was due more to failed communication than to real concerns about the eurozone’s economic health. In fact, as the second chart shows, ECB actions have helped the eurozone (light blue line) narrow the growth gap relative to the U.S. and U.K. (yellow and dark blue lines respectively).

WHAT IT MEANS FOR INVESTORS
Overreaction to the December ECB announcement may have created opportunities for investors who focus on fundamentals and maintain a long-term perspective. Active management and independent research remain critical in this region, where conditions are still evolving.
Emerging markets remain a potential source of volatility but PIMCO’s baseline view is 5.5%–6.5% growth in China and 1.25%–2.25% in BRIM.

WHAT THESE CHARTS SHOW
Many EM economies are export-intensive, so the trade balance is a good indicator of the potential for economic growth. Trade balance is the difference between what countries export and what they import. As the first chart shows, the EM trade balance (light blue line) and EM GDP (dark blue) have decelerated over the past few years. EM currencies weakened significantly in recent quarters, improving the competitiveness of their exports, but this process will take time. So, despite generally healthy balance sheets in EM, we are forecasting slowing growth and bouts of volatility over the cyclical horizon. In the case of China, we believe the central bank has the will and wallet to stabilize growth. The second chart shows the central bank’s efforts to date. By lowering the benchmark lending rate (light blue line) and reducing the amount banks are required to hold in reserve (dark blue line), the bank is pushing money into the economy. These measures are examples of the flexibility policymakers have to continue supporting growth.

INVESTMENT IMPLICATIONS
Investors will want to maintain a cautious stance with respect to emerging markets, but those who have a long-term perspective, an appreciation for the volatility, and an experienced active manager may find select opportunities at this time of market unrest.


Source: International Monetary Fund. Data as of 31 December 2015.
PIMCO is broadly neutral on equities, but within the asset class we believe shifting market conditions may create long-term opportunities for value strategies.

**WHAT THESE CHARTS SHOW**
The U.S. stock market (as represented by the S&P 500 Index) ended 2015 slightly positive. This broad market return may be misleading, however, as it does not fully reflect some underlying trends. For example, as the first chart shows, the 20 most expensive U.S. large stocks (green line) continued to outperform the 20 cheapest large stocks (blue line), defying the “buy low, sell high” adage. And as the second chart shows, those expensive stocks included four technology stocks that carried broad market results. The four stocks (dubbed “FANG” for Facebook, Amazon, Netflix and Google) rose 64.4% in 2015 (green line) versus the market’s 1.4% gain (blue line). Without this performance boost the stock market would have actually declined 0.3% (yellow line). How could this happen? The stocks in question have large market capitalizations (the S&P weights exposure in the index by market capitalization), and investors have driven up the prices of these popular names (most likely beyond sustainable levels). The result is a “narrow” market, meaning overall results are dependent on relatively few stocks.

**INVESTMENT IMPLICATIONS**
This type of skewed, narrow market should raise concern among investors. Long-term investors will want to focus on fundamentals and the potential benefits of a value strategy that may come into favor as market conditions shift.

**Source:** Factset. Data as of 31 December 2015. The representative 20 cheapest and 20 most expensive U.S. large stocks are based on a large-cap universe of 500 U.S. names, ranked by price-to-book.
PIMCO is favorable on TIPS given valuations relative to nominal bonds and our U.S. inflation forecast.

WHAT THESE CHARTS SHOW
While oil prices have been a drag on inflation in 2015, the first chart shows that falling oil prices have not always led to prolonged periods of low inflation. The green bars in the chart show the total change in oil prices during periods of significant declines. The associated blue bars show the annualized inflation for the five years following each of these oil market drawdowns. Even when oil prices fell by more than 66% in 2008, inflation averaged 2% over the next five years. So, while the market expects inflation of just 1.3% (dotted bar) going forward, PIMCO believes we will actually see higher inflation. The second chart shows that forecast, with inflation reaching 1.5%–2.0% over the next 12–18 months. The main driver of the increase will be the continued strength in the U.S. labor market. As job creation continues to rise and unemployment falls, wages should increase. Higher wages will likely lead to more consumer spending, and this increased demand will drive up prices. Higher inflation could be a catalyst for more normal inflation expectations, which in turn should support the performance of inflation-linked securities, such as TIPS (U.S. Treasury Inflation-Protected Securities).

INVESTMENT IMPLICATIONS
Inflation can quickly erode an investor’s buying power. Investors looking to add explicit inflation protection to their portfolio will want to consider an allocation to an actively managed portfolio of TIPS.

### PIMCO expects inflation to advance in 2016

Source: PIMCO, Bloomberg. Data as of 31 December 2015. Inflation represented by headline CPI.
PIMCO’s analysis shows fundamentals and valuations favor credit, including high yield.

**WHAT THESE CHARTS SHOW**

Fundamentals for high yield companies are generally solid. The first chart makes this case, showing interest rate coverage, which is the amount of earnings (before interest and taxes) generated relative to the interest expense owed. The current interest coverage ratio on high yield (excluding energy companies) is relatively high at about 3.5x. Many high yield companies benefit from lower energy prices. Moreover, because the majority of their operations are domestically focused, they don’t feel the impact of a strong dollar or potentially slower growth abroad. Combined with a supportive outlook for domestic growth and profit, these factors help explain why we expect a relatively low default rate outside the commodity producing sectors. The second chart compares the yield on high yield (dark blue line) and the free cash flow yield on equities (green line). Free cash flow yield is the free cash per share divided by the market price per share, providing an estimate of the yield an equity owner could theoretically earn. The difference between these yields is high, and with limited room for multiples to expand on stocks, credit valuations look relatively attractive.

**INVESTMENT IMPLICATIONS**

Long-term investors who are comfortable with the risks associated with high yield and who are willing to ride out bouts of volatility will want to consider this timely opportunity.
PIMCO believes bank capital will continue to remain an attractive alternative to equities and a complement to traditional credit investments.

**WHAT THESE CHARTS SHOW**

Global banks are boasting strong and improving balance sheets. The first chart shows core tier one capital ratios for global banks from 2007 through the end of 2015. Tier one capital is a measure of a bank’s financial strength from a regulator’s point of view. It shows how much core equity capital a bank holds against its assets (weighted by risk). Following the financial crisis, banks significantly increased their capital ratios in line with tighter regulation. As the chart shows, since then global banks have more than doubled their core tier one ratios from around 6% to 10–12%. And with additional leverage requirements and a tighter definition of capital ratios likely, we anticipate that these buffers will continue to rise, further improving the fundamentals of the sector. Valuations also remain attractive for bank capital securities, as seen in the second chart. The blue bars are the yields on European bank capital securities, which are higher than investment grade corporate bonds, and for tier one capital, higher than European high yield. In fact, capital securities are offering similar yields to U.S. high yield and emerging markets, while providing exposure to a sector that is expected to see improving financial strength.

**INVESTMENT IMPLICATIONS**

Investors seeking relative value opportunities will want to consider global bank capital securities, which offer attractive yield and the potential for price appreciation alongside improving fundamentals.

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**FINANCIAL MARKETS: BANK CAPITAL**

**Banks are operating with multi-decade high levels of capital**

Yields on bank capital securities (AT1, T2 CoCo) offer 2–3X investment grade corporates

Yields track HY and EM but with more positive fundamentals

Source: PIMCO, Bloomberg, Barclays, BofA Merrill Lynch, JPMorgan. US High Yield BB-B is represented by the BofA US High Yield BB-B Constrained Index, European AT1 is represented by the Barclays European Banks CoCo Tier 1 Index, Emerging Markets is represented by JP Morgan EMBI Global, Euro HY BB-B is represented by BofA BB-B Euro High Yield Index, European T2 CoCo is represented by the Barclays European Banks CoCo Tier 2 Index, Euro investment grade is represented by the Barclays Euro Aggregate Credit Index. Data as of 31 December 2015.

Source: PIMCO. Company filings based on Q2 ’15 results. Data as of 31 December 2015.
**Key topics** | **PIMCO’s outlook** | **Implications**
--- | --- | ---
Global economy | PIMCO expects the global economy to continue its modest expansion and for global inflation to grow faster | Consider a broader investment universe and more tactical shifts across and within an allocation strategy
U.S. economy | Continued growth of 2.0%–2.5% and inflation in the range of 1.5%–2.0% | Opt for a diversified, actively managed portfolio that can benefit from a moderately improving economy
European economy | The ECB’s QE program is continuing to have a positive impact on the economy | Active management and independent research remain critical in this region, where conditions are still evolving
EM economies | Emerging markets remain a potential source of volatility | Maintain a cautious stance and work with experienced active managers to find select opportunities
Equities | Broadly neutral on equities but see opportunities for value strategies | Be aware of narrow market risks and focus on fundamentals and long-term potential
TIPS | Favorable on TIPS given valuations relative to nominal bonds and our forecast of 1.5%–2.0% inflation in the U.S. | Add inflation protection before inflation occurs, potentially through an actively managed portfolio of TIPS
Credit | Fundamentals and valuations support high yield credit | Consider this timely opportunity as part of a diversified portfolio, recognizing the potential for bouts of volatility
Bank Capital | Bank capital will continue to remain an attractive alternative to traditional equity and credit investments | Consider global bank capital securities, which offer attractive yield and the potential for price appreciation alongside improving fundamentals
A word about risk

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 is 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. Equities may decline in value due to both real and perceived general market, economic and industry conditions. 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. High yield, lower-rated securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. 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. Bank loans are often less liquid than other types of debt instruments and general market and financial conditions may affect the prepayment of bank loans, as such the prepayments cannot be predicted with accuracy. There is no assurance that the liquidation of any collateral from a secured bank loan would satisfy the borrower’s obligation, or that such collateral could be liquidated. 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. Derivatives may involve certain costs and risks, such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. Investors should consult their investment professional prior to making an investment decision.
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