



## *A New Normal*

Last week, PIMCO colleagues from around the world converged on Newport Beach for our annual Secular Forum. This highly interactive and anticipated event informs and influences our investment positioning over time. Specifically, it defines the secular (3–5 year) guardrails for the higher frequency investment analyses that emerge from our quarterly Cyclical Forums, and from the Investment Committee’s sessions held four times a week.

This was not an easy Forum. Travelers had to navigate concerns related to the risk of a swine flu pandemic. We debated at length the wisdom of gathering so many people in a room for 2½ days. And all this took place well before we got down to the difficulties of deciphering an unusually blurry economic, financial, social and political environment.

Yet, as Bill Gross said to many of you at our March client conference, “PIMCO loves a challenge.” So we, individually and collectively, stepped up to the plate and dealt systematically with the many moving pieces that will define the secular outlook and potential range of variations.

Needless to say, many of us entered the discussions with priors and biases. After all, recent months have been dominated by unprecedented volatility in factors that have conventionally anchored market relationships. Indeed, some of you have already heard us argue that the world is traveling on a bumpy road to a new destination – or what PIMCO has labeled the “new normal.” And, reminiscent of what happened a few years ago with Bill Gross’s concept of a “stable disequilibrium” and Paul McCulley’s “shadow

banking system,” the notion of a new normal is increasingly resonating in policy circles and among market practitioners.

This reflects a growing realization that some of the recent abrupt changes to markets, households, institutions, and government policies are unlikely to be reversed in the next few years. Global growth will be subdued for a while and unemployment high; a heavy hand of government will be evident in several sectors; the core of the global system will be less cohesive and, with the magnet of the Anglo-Saxon model in retreat, finance will no longer be accorded a preeminent role in post-industrial economies. Moreover, the balance of risk will tilt over time toward higher sovereign risk, growing inflationary expectations and stagflation. But, hold on, I am getting ahead of myself here. I still have a few more preambles!

Yes, we entered the Forum with priors and biases. So it was even more important to have them tested by the views of knowledgeable outsiders. Accordingly, and consistent with the tradition established many years ago, we invited outside speakers known for their independent thinking and provocative analysis. They did not disappoint.

Our discussions were enhanced by insights offered by Willem Buiter, Peter Costello, Bill White, and Fareed Zakaria (see box on the next page). Once again, we had the privilege of Alan Greenspan (former Federal Reserve Chairman) and Mike Spence (Nobel laureate in Economics) sitting at the table offering their thoughts and reactions. In the same spirit of intellectual openness and challenge, we gave the floor to our talented class of new MBAs so

that they could also throw into the mix ideas that are still heavily influenced by their non-PIMCO past. Boy did they impress!

## The Context

The context for this year's Secular Forum was defined by three distinct factors.

First, delineating where markets are coming from – or, to use the PIMCO phraseology, the “initial conditions.” We found ourselves drawn back to the 2008 Secular Forum's characterization of the global system having reached a “dead end:” unable to continue on its recent path due to debt exhaustion and poorly capitalized activities, yet also incapable of embarking smoothly on a different path as the ravages of de-leveraging result in disruptive overshoots and considerable collateral damage.

Second, recognizing that since the last Secular Forum, the global economy and markets suffered what economists call a “sudden stop” after the disorderly failure of Lehman Brothers in mid-September: every section of the rich data book for the Forum highlighted the severity of this cardiac arrest, raising legitimate questions regarding the depth and duration of the underlying breakage.

Third, arguing that recent events extended the de-leveraging dynamics into a broader phenomenon with longer-term consequences: the DDR, to use the terminology of one of Bill's recent *Investment Outlooks*. This potent cocktail – a self-reinforcing mix of *De-leveraging*, *De-globalization*, and *Re-regulation* – inevitably entails economic and political forces that disrupt the normal functioning of markets and the global economy.

Together, these factors constituted a strong unanticipated blow to the gut of virtually every economy. (See Charts 1 and 2 for an illustration). Most are still on the floor trying to regain their breath. Indeed, as one of our external speakers put it, if you were the global economy, you would not wish to start

## PIMCO's 2009 Secular Forum Speakers

**Professor Willem Buiter**, Professor of European Political Economy at the European Institute of the London School of Economics and Political Science; former member of the Bank of England's Monetary Policy Committee and Chief Economist of the European Bank for Reconstruction and Development

**The Hon Peter Costello MP**, Australia's longest-serving Treasurer (1996–2007) and Deputy Leader of the Liberal Party

**Dr. William White**, former Economic Adviser and Head of the Monetary and Economics Department, Bank for International Settlements

**Fareed Zakaria**, best-selling author, editor of *Newsweek International* and host of *Fareed Zakaria GPS* on CNN

a journey from here; yet, you also cannot go back to where you were.

If it had been left to its own devices, the global economy would have gone through an even more wrenching cleansing process. Unemployment would be spiking even higher, additional institutions would be failing and larger market segments, nationally and internationally, would be dysfunctional.

No democratically elected government is able to stand on the sideline when its electorate faces such a situation. Almost regardless of political persuasion – and, more importantly, of whether they have the right diagnosis and tools – governments inevitably find themselves dragged in to address the mounting damage to human welfare. In the process, they resort to unconventional responses that, by definition, are uncertain in their effectiveness yet consequential in disrupting some long-standing relationships. Think of this as the economic

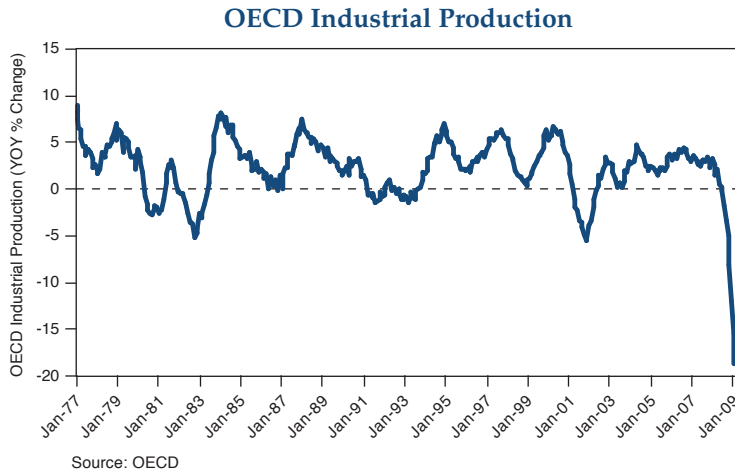


Chart 1

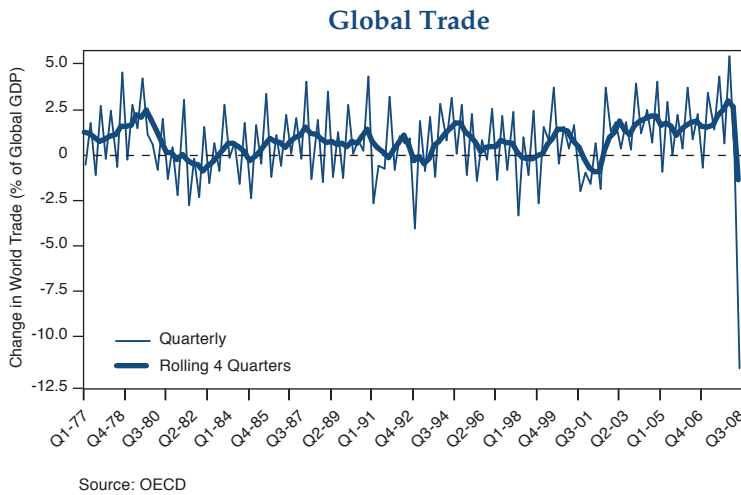


Chart 2

equivalent of a drug trial being applied to huge populations: there is a case for the medicine, yet there also remains considerable uncertainty about effectiveness, lags and side effects.

The alternative to the exceptional scale and scope of recent government intervention could well have been worse. Nevertheless – and especially for people like me who, in a previous career at the IMF, lived through various experiments with forms of directed credit, price controls, import substitution and industrial policies – it is discomfoting to see the public sector become a notable price setter in

certain markets. It is even more discomfoting to see it own and control some modes of production, exchange and distribution that normally (and should) reside only in the hands of private enterprise. The public sector's role as major supplier and allocator of credit is also unsettling.

Given the initial conditions of the global system and the strong medication being administered by governments, the major intellectual and analytical challenge for our Forum was to figure out how the process of “getting up off the floor” would evolve over the secular

horizon. Would it be simultaneous or sequential? Would those managing to get up pull others up with them, or would they push them down farther? And how long would it take for those able to get up to stand up straight again?

In the process, we inevitably found ourselves discussing how the balance would play out among such complex factors as:

- Past market failures vs. future government failures
- Paper wealth destruction vs. real wealth destruction
- Globalization vs. nationalism
- Economic desirability vs. political feasibility.

## What Now?

It was clear to us that, despite the very high hurdle that we always apply to such a statement, the world has changed in a manner that is unlikely to be reversed over the next few years. Put another way, markets are recovering from a shock that goes way, way beyond a cyclical flesh wound.

It is not just about the major realignment of the financial system and the extent to which governments have intervened to offset market failures. And it goes beyond the massive increase in government deficits and government debt in virtually every systemically important country in the world (at a time when few countries can credibly pre-commit to the type of fiscal primary surplus required to subsequently reverse the massive deterioration in the debt dynamics).

It's also about the structural change in how savings are mobilized and allocated, nationally and across borders. It is about the shifting balance between the public and private sectors. And we should not forget the potentially long-lasting consequences of the erosion of trust in such basic parameters of a market system as the sanctity of contracts and property rights,

the rule of law, and the robustness of the capital structure. Such trust can be lost quickly but takes a long time to restore.

The result is a prolonged pause, or in some cases, a violent reversal in certain concepts that markets had taken for granted. We referred to it as the demise of the "great age" of private leverage, asset- and credit-based entitlements, self-regulation, policy moderation, and shrinking direct government involvement. Not surprisingly given the extent of the gains that were privatized and the losses that are now being socialized, the demise is occurring in the context of popular anger, confusion and what one of our speakers called "a morality play" in parliaments around the world.

This is not to say that the global economy has no defenses. It has. Policymakers are fully engaged in an effort to avoid another Great Depression. The secular forces of productivity gains and entrepreneurial dynamism will not disappear. And there are pockets of considerable economic and social flexibility, high self-insurance, and even some global policy coordination.

Yet, while these factors help reduce the risk of a deflationary depression, they are not strong enough for a return to the high growth and low inflation that characterized 2002–07. Simply put, there are insufficient demand buffers and fast-acting structural reforms to provide for a spontaneous and sustainable recovery in the global economy.

No wonder we have characterized the financial crisis as a crisis *of* the global system (as opposed to a crisis *within* the system). Lacking endogenous circuit breakers, the system will not reset quickly and without permanent changes (and some would argue that even if it could, it should not). For markets that are highly conditioned by the most recent periods of "normality," this will feel like a *new normal*. Indeed, it will be a major shock to those that are trapped by an overly dominant "business-as-usual" mentality.

## The New Normal

For the next 3–5 years, we expect a world of muted growth, in the context of a continuing shift away from the G-3 and toward the systemically important emerging economies, led by China. It is a world where the public sector overstates as a provider of goods that belong in the private sector. (As one of our speakers put it, we have transitioned from a world where the private sector provided public goods to one where the public sector provides private goods.) It is also a world in which central banks and treasuries will find it difficult to undo smoothly some of the recent emergency steps. This is particularly consequential in countries, such as the U.K. and U.S., where many short-term policy imperatives materially conflict with medium-term ones.

The banking system will be a shadow of its former self. With regulation more expansive in form and reach, the sector will be de-risked, de-levered, and subject to greater burden sharing. The forces of consolidation and shrinkage will spread beyond banks, impacting a host of non-bank financial institutions as well as the investment management industry.

How does inflation behave in the new normal? For now, it is hard to project any imminent pickup in inflation given the severity of the collapse in global demand and the resulting large output gap. Private components of global demand will not recover quickly and fully. Yet, one should not fixate just on demand when transitioning from a cyclical to a secular mindset. Supply also matters.

In the next few years, the historical pace of growth in potential output will face many headwinds. Excessive regulation, higher taxation, and government intervention will be among the factors that will constrain the growth of potential (non-inflationary) output (Chart 3, prepared by Ramin Toloui, conceptualizes the process). With investment activity subdued for a while, the rate of depletion of the capital stock will rise. There is also the loss of endogenous credit factories that, especially in their overheated 2004–07 phases, fooled people into believing that the increase in leverage-based economic activities was sustainable.

The most animated discussion in our Forum related to another aspect that will govern

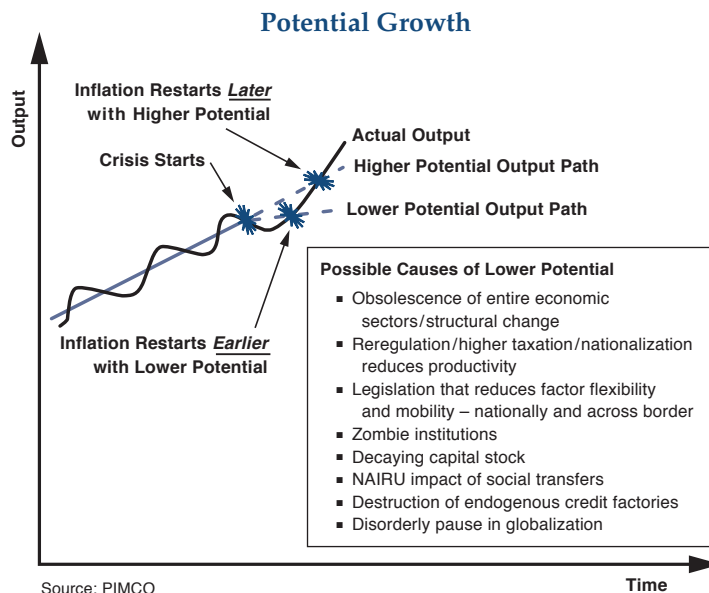


Chart 3

inflation dynamics in the new normal: whether the massive amount of fiscal and monetary stimulus adopted by the U.S. authorities will erode confidence in the public goods that the country provides to the rest of the world – namely, the dollar as *the* world's reserve currency, and deep and predictable financial markets to intermediate excess savings.

In its weakened state, the U.S. can ill afford a reduction in the “implicit rents” it collects for providing such public goods. Otherwise, inflation will take off much earlier than recent history would suggest. Even more consequential, over time the U.S. would retain less control over its economic and financial destiny, thereby slowly assuming the characteristics of what economists label as “small open economies.” This is a fundamentally unattractive possibility not only for the U.S. but also for most other countries. None of them (let alone regions and multilateral bodies) is able and willing to assume the responsibilities at the center of the global system.

In the new normal, bottom up issues will actively compete with top down themes. The power of the convergence magnet – that mystical Anglo-Saxon model of liberalization and de-regulation where a prosperous post-industrialization phase relies on an ever-booming financial system – has weakened. No other model is able to step in at this stage. Accordingly, the partial vacuum will translate into country differentiation relative to what has taken place in the recent past.

Think of the following potential configuration:

- We would look for financial rehabilitation in the *U.S.* to occur in the context of low growth and an eventual inflationary bias down the road.
- The *U.K.* would also be stuck in a low growth world, but with greater vulnerability to domestic and/or external financial instability.

- Core *Europe* will also grow slowly, influenced by its historical inflation phobia and concerns for the integrity of the European Union.
- *Japan* will continue to face growth headwinds as its economy is too encumbered by fiscal and demographic issues.
- *Emerging economies* will bifurcate more clearly into two groups. Those with weak initial conditions will return to the old emerging market paradigm that alternates between austerity and financial instability; those with strong initial conditions will maintain their development breakout phase, albeit not at the torrid pace of recent years.

## Risk Scenarios

These factors pose interesting questions for long-term investments: Over the secular horizon, will global low growth transition into even more unpleasant stagflation? Will some central banks' current efforts to repress real interest rates throughout unusually large segments of the yield curve succumb in a disruptive fashion to the dark forces of higher inflationary expectations and sovereign risk spreads?

At present, such transitions constitute important risks to our secular baseline. They are not the only ones in what, unfortunately, is a “balance of risk” picture that is tilted to the downside.

John Maynard Keynes, whose thinking dominated the inter-war economic debate and whose influence is obvious today in many policy circles, is said to have stated: “When the facts change, I change my mind. What do you do, sir?” In this spirit, let me share with you other risk factors that we will be following closely in the months ahead.

First, politics matter a great deal. Over the next few months, political feasibility (rather than economic desirability) will dictate most economic policy responses. Given the fragility of the global system, the world can ill afford

a new round of policy mistakes and political unpredictability. Protectionist measures would be particularly harmful, as would steps that undermine the image of the U.S. as a responsible shepherd of other countries' savings.

The political dimension is not limited to the next few months. Farther down the road, political commitment will be needed to drain the system of emergency liquidity – a task complicated by the strong possibility that the U.S. and U.K., in particular, will face a reduction in trend growth rates at a time of increasing pressure to lower unemployment. Remember, the evidence of recent years is that governments are reluctant to impose short-term pain for long-term gain.

Second, the healthy functioning of markets (and societies at large) depends on a set of implicit contracts – what our MBAs labeled social contracts. As is often the case in emergency situations, these contracts are being subjected to major shocks. For many, a disturbingly large number of parameters that anchor key behaviors have become variables. The longer it takes to restore normalcy, the higher the risk of recurrent financial instability.

Third, the management of public debt in industrial countries will be a delicate process. For sure, the numbers going forward are very, very large – in terms of both stocks and flows. The starting point, including the fact that the average maturity of outstanding U.S. debt is at the lowest (i.e., most vulnerable) seen for some 25 years, is far from reassuring. Also, let's not forget that, in a few years' time, very large unfunded entitlements (Social Security and Medicare) will start to significantly hit the budget.

Fourth, any further erosion in the autonomy and mission of key economic institutions, including the Federal Reserve and to a lesser extent the FDIC, would be terrible news. Governments must resist the temptation to

co-opt further such institutions, saddling them with fiscal activities that lack sufficient transparency and belong with the budgetary process. The lessons of history are unambiguous on this: the weakening of key institutions serves to adversely impact risk premiums across many markets.

Fifth, even our muted projections for global growth assume some important handoffs that are inherently difficult and face large time-inconsistency challenges. Remember, we are postulating that continued robust growth by some major emerging countries (particularly Brazil, China and India) will serve to partially offset the lower growth in the G-3 and the U.K. We are also postulating that growth in these countries will be driven by a significant pickup in the consumption of an expanding middle class.

## Investment Implications

While the Forum process was intellectually exhausting, it yielded a rich menu of strategic insights – starting with secular investment positioning and extending into product design, client servicing and business management.

With regard to our secular investment guardrails, our baseline favors the front end of yield curves in many countries (as the authorities overstay with negative real policy rates), income-generating instruments (which will dominate the pure equity premium), and an international orientation (as the U.S. faces the prospects of a plateau shift in sovereign risk and the return of higher inflationary expectations). It specifically argues for

- Exploiting periodic anomalies associated with clumsy internal and external handoffs
- Favoring credit spreads higher up in the economic and capital structure and, increasingly, on an even more international basis

- Remembering that premiums across risk factors and markets will reflect in a seemingly permanent fashion the bout of disruptions to the sanctity of contracts and the capital structure, as well to the autonomy of key economic institutions
- Positioning for the eventuality of renewed depreciation of the dollar, keeping in mind that the magnitude of depreciation against other currencies could potentially be outpaced by that vis-à-vis real assets
- Recognizing that the equity risk premium will now reflect a permanently higher threat of subordination.

Over the next weeks, our specialist desks around the world will be working on assessing the implications of these factors for specific strategies, asset classes and products.

## In Sum

Markets will revert to a mean, but it will not look anything like that of recent years. Relative to where it is coming from, the financial system will be de-levered, de-globalized, and re-regulated. Global growth will be lower and unemployment higher, notwithstanding the continued rotation of dynamism away from industrial countries and toward emerging economies. Price formation in many markets will be influenced by the legacy and, in some cases, continuation of direct government involvement. Burden sharing will feature more prominently, being one feature of the heavier hand of government in economic life.

For a financial industry known for its famously short memory (and related infrastructures and behavior), this will feel like a new normal. Adaptations will be needed as the configuration of risks and returns shift, government debt balloons, and capital structures potentially migrate toward a simplified structure consisting just of equity and senior debt instruments. Business models will need to be retooled, and investment management vehicles made more responsive and robust.

These issues will be front and center on our radar screens as we navigate the resources that you have entrusted to us. Indeed, in closing, allow me to quote from Bob Dylan's song, "Forever Young," which (italics added) expresses a simple notion that will influence how PIMCO navigates with you the bumpy journey to this new normal:

May your hands always be busy  
 May your feet always be swift  
*May you have a strong foundation  
 when the winds of change shift*

Thank you.

Mohamed A. El-Erian  
 CEO and Co-CIO

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