PIMCO

CYCLICAL OUTLOOK

December 2017

Peak Growth

We expect the global expansion to continue in 2018. Yet investors should prepare for both the consequences of policy shifts and the opportunities presented in more difficult market conditions.

A company of Allianz

AUTHORS

Joachim Fels
Global Economic Advisor

Andrew Balls
Chief Investment Officer
Global Fixed Income

The good news first: Barring a zombie apocalypse or a sudden spontaneous collapse in asset prices, the current Goldilocks environment of synchronized, above-trend global economic growth and low but gently rising inflation will likely persist in 2018.

In fact, recent growth momentum has been even better than expected across many economies, providing a strong ramp into next year. Moreover, easier financial conditions (reflecting buoyant markets for risk assets and still-low interest rates) imply sustained near-term tailwinds, and fiscal stimulus in the U.S. and elsewhere in the advanced economies is forthcoming. Meanwhile, China keeps suppressing domestic economic and financial volatility while fundamentals in many other emerging market (EM) economies continue to improve. Taken together, PIMCO's baseline forecast is for world real GDP growth in a 3% to 3.5% channel in 2018, about the same as in 2017 and a quarter point higher than in our September forecast.

However, a Goldilocks-extended scenario is very much baked into the consensus and asset prices. During our December Cyclical Forum we expressed confidence in our baseline economic prognosis, and we zoomed in on the potential shorter- and longer-term consequences of synchronized global growth, fiscal stimulus in the U.S. at a time of already high resource utilization and the reduction of monetary accommodation by major central banks. In a nutshell, we concluded that 2017–2018 could well mark the peak for economic growth in this cycle and that investors should start preparing for several key risks that lie ahead in 2018 and beyond. Here's why:

BORROWING FROM THE FUTURE

First, the prospective U.S. fiscal expansion in 2018 – worth close to 0.5% of GDP in 2018, half of which is likely to come from tax cuts and half from higher federal spending – appears dictated by the political cycle rather than the economic cycle. Fulfilling last year's presidential election campaign promises and delivering tax cuts and spending increases ahead of next year's congressional midterm elections makes political sense but could have detrimental longer-term economic consequences. Why?

Arguably, the last thing an economy operating at close to full employment in the ninth year of an economic expansion needs is a shot in the arm from fiscal policy:

- Adding around $1 trillion to the public debt over 10 years (according to the Joint Committee on Taxation estimates) without adding much to potential growth and thus future tax revenues looks manageable while interest rates are low, but would come back to haunt the public coffers if rates rise in the future.
- Most importantly, depleting the fiscal toolkit while the economy is good comes at a price: Higher fiscal deficits and debt levels imply that the room for fiscal stimulus in the next recession will be more limited.

BEND IT LIKE A.W.H. PHILLIPS?

A second major risk related to the 2018 outlook is that wage and/or price inflation may finally inflect higher as employment overshoots its natural level.

There are good reasons why this hasn't happened so far and why the Phillips curve describing the link between (falling) unemployment and (accelerating) wages/prices has thus remained fairly flat:

- Globalization and technology have reduced workers' bargaining power.
- Low productivity growth has curtailed the scope for real wage gains.
- "Pent-up wage deflation" due to the inability or unwillingness of firms to cut nominal wages in the Great Recession of 2008–2009 had to run its course.
- The recent rise in labor force participation held wage gains down.

However, the risks of a cyclical inflation overshoot in 2018 are rising given the globally synchronized nature of the expansion, additional fiscal stimulus, recent rises in commodity prices and super-easy financial conditions. Global structural forces are still weighing down inflation, but the cyclical pressures are clearly on the up.

THE RISK OF MONETARY OVERKILL

A third risk for 2018 is that the reduction of monetary accommodation – well-intentioned as it may be given decent cyclical growth – turns out to be too onerous for economies and asset markets that have become addicted to low short rates and depressed term premia across the yield curve. Here's our monetary policy baseline for 2018:

- Our baseline expectation is for the U.S. Federal Reserve to raise rates three more times in 2018, taking the fed funds rate range to 2%–2.25% by the end of 2018. Meanwhile, the Fed's balance sheet will shrink on autopilot at a pace that will accelerate quarterly in 2018.
- The European Central Bank (ECB) will likely end its bond purchases by the end of 2018 and signal a first rise in short rates in 2019.
- We expect the Bank of Japan (BOJ) will aim to reduce balance sheet expansion in 2018 and/or tweak its yield curve control policy toward curve steepening, which could contribute to a rise in global term premia.

With markets having become used to and addicted to easy monetary policies, this turn in the tide of global central bank policies poses significant risks to markets and economies, particularly as the new and still-evolving Fed leadership is untested.

ABOUT OUR FORUMS

PIMCO's investment process is anchored by our Secular and Cyclical Economic Forums. Four times a year, our investment professionals from around the world gather in Newport Beach to discuss and debate the state of the global markets and economy and identify the trends that we believe will have important investment implications. We believe a disciplined focus on long-term fundamentals provides an important macroeconomic backdrop against which we can identify opportunities and risks and implement long-term investment strategies.

At the Secular Forum, held annually, we focus on the outlook for the next three to five years, allowing us to position portfolios to benefit from structural changes and trends in the global economy. Every Secular Forum, we invite distinguished guest speakers – Nobel laureate economists, policymakers, investors and historians – who bring valuable, multi-dimensional perspectives to our discussions. We also welcome the active participation of the PIMCO Global Advisory Board, a team of five world-renowned experts on economic and political issues.

At the Cyclical Forum, held three times a year, we focus on the outlook for the next six to 12 months, analyzing business cycle dynamics across major developed and emerging market economies with an eye toward identifying potential changes in monetary and fiscal policies, market risk premiums and relative valuations that drive portfolio positioning.

Regional economic forecasts: around the globe in five minutes

And here's our 2018 outlook for the major economies:

U.S.

Factoring in larger-than-expected tax cuts and higher federal spending, we now look for above-trend real GDP growth of around 2.5% in 2018. We expect household and corporate tax cuts to boost growth by 0.2 to 0.3 percentage points in 2018. Another 0.2 percentage points will come from higher government spending that reflects hurricane-related disaster relief appropriations and a likely rise in discretionary spending limits as part of an expected government funding compromise.

With the unemployment rate likely to drop below 4%, we expect some upward pressure on wage growth and consumer price inflation, with core CPI inflation rising above 2% in the course of the year. Core PCE inflation, the Fed's preferred measure, should rise as well, to 1.7% from 1.4% currently, making some limited progress toward the 2% objective.

Under the new leadership, the Fed is likely to continue to push the fed funds rate gradually higher as slack in the economy erodes. The current median Fed projection for three rate hikes in 2018 – one more than markets now price in – looks like a reasonable baseline assumption, with roughly equal risks on both sides. If financial and economic conditions remain favorable throughout the year, four rate hikes are entirely possible. Conversely, an abrupt tightening of financial conditions and/or further downside surprises on inflation could slow the pace of rate hikes to only two in 2018.

EUROZONE

With recent growth momentum strong and financial conditions favorable, we expect the eurozone economy to continue to grow at about 2.25% in 2018, the same pace as the year before. A key feature of the current expansion is that the recovery is now broad-based across the region, with much less dispersion in member states' growth rates than in earlier years.

Another key feature of this expansion is that core inflation has been and is expected to remain very low, creeping only marginally above 1% in the course of next year. Remaining slack, past labor market reforms and persistent competitiveness gaps between member states are holding wage pressures down. Moreover, the appreciation of the euro in the course of 2017 will likely damp consumer price inflation in 2018.

ECB policy is on autopilot for now, with net asset purchases set to halve to €30 billion per month through January to September. We expect quantitative easing to end then, though maturing bonds will be reinvested for an extended period of time. We don't expect the first rate increase until around mid-2019, which is beyond our cyclical horizon. However, the discussion in the ECB Governing Council and in financial markets about the timing of the first hike is likely to heat up during the second half of 2018.

UK

Our above-consensus forecast of around 1.5% real GDP growth in the UK next year is based on the expectation that a deal on a transitional arrangement to smooth the UK separation from the EU will be struck in the first half of 2018. If this happens, we expect growth to reaccelerate as confidence picks up and some pent-up business investment is approved. Also, following seven years of austerity, we see some scope for stronger government spending.

Inflation should fall back to the 2% target by end 2018 as the import price effect from last year's sterling depreciation fades and there are still no signs of second round effects on consumer prices. We expect the Bank of England (BOE) to continue with a very gradual path of interest rate rises, with our central expectation of one to two hikes over 2018. That is predicated on relatively smooth negotiations between the UK and EU over Brexit. Whilst not our expectation, if the talks do break down it is still possible that the BOE leaves rates unchanged.

JAPAN

Our base case scenario for Japan foresees a continuation of firm growth of around 1.25% in 2018, with risks tilting on the upside. Fiscal policy remains supportive in 2018 ahead of the planned value-added tax hike in 2019. With the unemployment rate below 3% and growth of (better-paid) full-time jobs accelerating, wage growth should pick up further, which should help core inflation accelerate gradually toward 1% in the course of 2018.

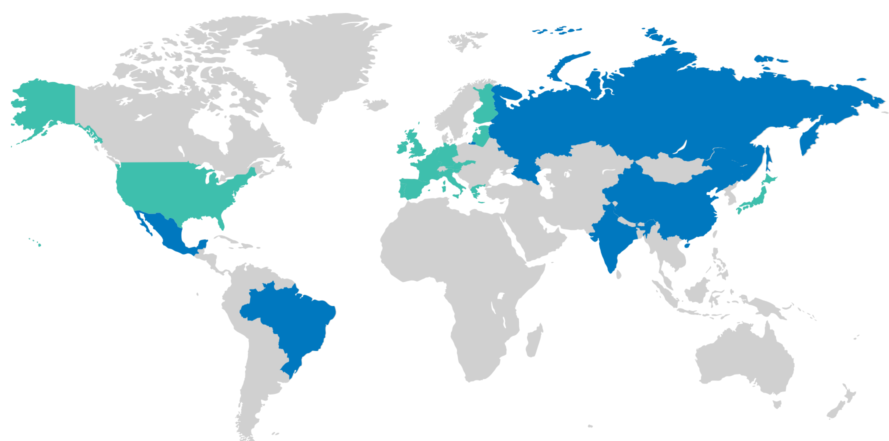
Against the backdrop of continued above-trend growth and rising inflation, we expect the Bank of Japan to aim at slowing the balance sheet expansion and/or tweak its yield curve control policy such that the curve steepens. This could be done either by adjusting the target for the 10-year yield higher, or by shifting the current 0% yield target to shorter maturities, e.g., the seven-year sector, thus creating room for longer-dated yields to rise.

CHINA

With much of the credit and infrastructure stimulus having peaked, we expect a controlled deceleration of China's GDP growth to around 6.25% in 2018. The authorities' focus is likely to be on controlling financial excesses, particularly in the shadow banking system, and on some fiscal consolidation, chiefly by local governments.

We expect inflation to accelerate to 2.5% on stronger core inflation and higher oil prices. This should induce the People's Bank of China to tighten policy by raising official interest rates, versus consensus expectations for no hikes. We are broadly neutral on the currency and expect the authorities to continue to control capital flows tightly in order to keep exchange rate volatility low.

GROWTH OUTLOOK FOR 2018 (GDP RANGE)



	REAL GDP GROWTH (% YOY)			CPI INFLATION (% YOY)		
	2016	2017 FORECAST	2018 FORECAST	2016	2017 FORECAST	2018 FORECAST
DM[1]	**1.5**	**2.1**	**1.75 - 2.25**	**0.7**	**1.7**	**1.5 - 2.0**
U.S.	1.5	2.3	2.25 - 2.75	1.3	2.0	1.75 - 2.25
Eurozone	1.8	2.3	2.0 - 2.5	0.2	1.5	1.0 - 1.5
UK	1.8	1.5	1.25 - 1.75	0.7	2.7	2.25 - 2.75
Japan	1.0	1.5	1.0 - 1.5	–0.1	0.5	0.75 - 1.25
EM[2]	**5.1**	**5.4**	**5.25 - 5.75**	**3.5**	**2.4**	**2.75 - 3.25**
China	6.7	6.7	5.75 - 6.75	2.0	1.6	2.0 - 3.0
Brazil	–3.6	0.7	2.0 - 3.0	8.8	3.6	3.75 - 4.75
Russia	–0.3	1.8	1.5 - 2.5	7.1	3.8	3.25 - 4.25
India	7.9	6.3	7.0 - 8.0	5.0	3.2	4.0 - 5.0
Mexico	2.9	2.1	2.0 - 3.0	2.8	5.9	3.25 - 4.25
World[3]	**2.7**	**3.2**	**3.0 - 3.5**	**1.6**	**1.9**	**2.0 - 2.5**

Note: All data for real GDP and headline inflation are year-over-year (YOY) percentage changes.
[1] DM is the GDP-weighted average of U.S., eurozone, UK and Japan.
[2] EM is the GDP-weighted average of China, Brazil, Russia, India and Mexico.
[3] World is the GDP-weighted average of all countries listed in table above.
Source: Bloomberg, PIMCO calculations

Investment implications

Given these risks, starting valuations and low volatility, we expect to be cautious in our overall portfolio positioning, focusing on diversified sources of income across our portfolios, without overly relying on one sector or beta, and above all maintaining portfolio flexibility.

The baseline outlook is for fairly range-bound markets. But an increasingly synchronized global expansion, U.S. fiscal expansion very late in the cycle, rising risks of a cyclical inflation overshoot and global removal of monetary accommodation mean we want to maintain flexibility. By positioning defensively, we believe we will be better prepared to take advantage of opportunities presented in more difficult market conditions rather than having to play defense – and to outperform in more difficult markets.

We expect to be moderately underweight duration in our generalist portfolios. In the baseline we expect fairly range-bound global markets and, at the same time, given overheating and central-bank-related risks, we see an increased risk of a break higher in the range. We expect to be underweight in the UK, given valuations, and we also favor an underweight duration position in Japan, based on both an expected adjustment in the BOJ's yield curve targeting regime and the expectation that Japanese yields would rise upward amid a broader shift higher in global rates.

We expect to have curve-steepening positions in our portfolios, in particular in the U.S., given the flatness of the curve and the expectation that we will see both re-establishment of term premia and inflation compensation, and less gravitational pull as the result of global central bank stimulus, along with more U.S. Treasuries supply.

We see U.S. TIPS (Treasury Inflation-Protected Securities) as offering attractive valuation, diversification versus corporate credit and a valuable hedge in case higher inflation risks amid late-cycle fiscal expansion in the U.S. are realized.

Emerging market currencies are our preferred way to gain EM exposure (via a broad basket of currencies), which we also see as a diversifier versus other portfolio positions and another source of carry.
We also expect to find other attractive targeted opportunities in EM local and external markets.

We want to be more selective on generic investment grade and high yield corporate credit, which we don't see as attractively priced and see as vulnerable in the event of a more difficult market environment. Instead we will look to apply the best bottom-up ideas from our global team of credit portfolio managers and analysts, and to emphasize short-dated and default-remote "bend-but-don't-break" corporate positions. U.S. non-agency mortgages and other global securitized assets we continue to see as offering both relatively attractive valuations plus relative seniority in the capital structure and reasonable compensation for liquidity and uncertainty over the timing of cash flows. We see U.S. agency mortgage-backed securities as offering reasonable valuations and a contribution to a broadly diversified set of income-generating positions.

Overall, we don't need to rely on heavy concentrations in tight corporate credit or less liquid credit in order to construct portfolios likely to generate income via a diversified set of positions and to outperform benchmarks if our baseline outlook is realized. We also position portfolios to benefit from a rise in term premia/inflation risk premia and maintain flexibility and liquidity, leaving us room to take advantage of more attractively priced opportunities in the event of a more difficult market environment.

PIMCO

Past performance is not a guarantee or a reliable indicator of future results.

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 are 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. **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. 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. Currency rates** may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. **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. **Mortgage- and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government-agency or private guarantor, there is no assurance that the guarantor will meet its obligations.

There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

This material contains the opinions of the manager and such opinions are subject to change without notice. This material has been distributed for informational purposes only. Forecasts, estimates and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

Newport Beach Headquarters
650 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

Hong Kong

London

Milan

Munich

New York

Rio de Janeiro

Singapore

Sydney

Tokyo

Toronto

Zurich

pimco.com
blog.pimco.com

CMR2017-1212-305546

PC263_55811