The Outlook for the U.S. and Global Economy, and the Financial Markets

Tony Crescenzi

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Biography

Tony Crescenzi

Mr. Crescenzi is an executive vice president, market strategist and portfolio manager in the Newport Beach office. Prior to joining PIMCO in 2009, he was chief bond market strategist at Miller Tabak, where he worked for 23 years. Mr. Crescenzi has written five books, including his latest, "Beyond the Keynesian Endpoint," which was published in November 2011, and a complete revision to Marcia Stigum's "The Money Market." He regularly appears on CNBC and Bloomberg television and in financial news media. Mr. Crescenzi taught in the executive MBA program at Baruch College from 1999-2009. He has 29 years of investment experience and holds an MBA from St. John's University and an undergraduate degree from the City University of New York.
Agenda

Today’s themes:

- Latest developments in Europe and China
- PIMCO’s cyclical economic outlook
- The outlook for fiscal and monetary policy
- Investment strategy
Europe

Short maturities in Europe are protected by the ECB’s conditional promise of support and they benefit from significant “roll down”

As of 30 September 2012
SOURCE: Bloomberg, PIMCO calculations
Refer to the Appendix for additional outlook information.
Europe

The ECB’s money printing has alleviated Europe’s debt problem but it can’t solve it

To create debt sustainability, Europe must address its cash flow problem by implementing structural reforms and restoring its:

- Growth
- Competitiveness
- External balance

Absent actions taken to restore the above, Europe faces continuous risk from these three “R’s”:

- Rating
- Rollover
- Restructuring

Refer to the Appendix for additional outlook information.
China’s growth rate is set to slow from its usual 8% to 10% pace

A new model of growth is emerging and it is necessary for China to avoid the "middle-income trap"
China’s Prospective Right Tail: 18th Party Congress Outcome Shows Fighting Back Against “Policy by Committee” Paralysis

#1. President Xi named military commander-in-chief vs. outgoing President Hu.

#2. President Xi & Premier Li poised to be only members serving full 10 year term.

#3. Politburo Standing Committee reduced from 9 to 7 members.

SOURCE: Recent announcements by China

President Xi
PIMCO’s Cyclical Economic Outlook
Support for U.S. economic growth

Top positive factors for the U.S. economy:

- Housing
- Fracking and factories
- Credit and cars
- Reduced drag from state and local governments
- Advancements in private-sector deleveraging
- Reversal of economic damage wrought by Mother Nature in 2012

Refer to Appendix for additional outlook information.
The vacancy rate is falling, boosting multi-family construction

- Homeowner vacancy rate for all dwelling units:
Housing: Fundamentals favor increased demand for shelter, including from “mama’s boys”

- The rate of new household formations is reverting back to pre-crisis levels of 1.0M - 1.5M households per year
- The crisis created an additional 800k new households with adult offspring older than 30 years old living with parents, and 1.2M new co-owner or co-renter households

Source: Census, American Housing Survey
Fracking and factories

Five supporting factors for the factory sector:

- Persistent strength in the Japanese yen
- Supply-chain diversification
- Increase in labor costs in China
- Increase in U.S. competitiveness
- Decline in the price of natural gas

Refer to Appendix for additional outlook information.
Fracking and factories

U.S. energy production is rising sharply

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**Diagram Description:**

- **Title:** Total oil (includes biofuels and refinery buildout); (LHS)
- **Subtitle:** Dry natural gas (RHS)

**Graph Details:**

- **Y-axis 1:** Thousands of barrels/day
- **Y-axis 2:** Million cubic feet/day

**Lines:**

- **Gold Line:** Total oil (includes biofuels and refinery buildout)
- **Blue Line:** Dry natural gas

**Source:** EIA, PIMCO
Myth: Banks aren’t lending

U.S. Commercial Bank Loans & Leases Outstanding
(in billions of dollars)

As of 31 December 2011
SOURCE: Federal Reserve
Time for a new car?

**CARS ARE OLDER**

Average Age of U.S. Passenger Cars

**CREDIT CONDITIONS HAVE IMPROVED**

AVERAGE CREDIT SCORES – NEW AUTO LOANS

As of 30 September 2011
Government spending: State and local budgets

After losing 700k jobs, state and local governments are stabilizing and will no longer subtract from GDP.

As of 31 October 2012
SOURCE: Center on Budget and Policy Priorities and the Bureau of Labor Statistics
Household payment obligations are at their lowest since 1994

Source: Federal Reserve
Mother Nature

Expect positive GDP impact from inventory replenishment and reconstruction activity related to Hurricane Sandy

Worst U.S. drought in 50 years

Seaside, NJ, after Hurricane Sandy
Headwinds to Economic Activity
Headwinds to U.S. growth

Three major forces remain big negatives:

WEALTH DESTRUCTION

INCOME GROWTH

MORTGAGE CREDIT AVAILABILITY

As of May 31, 2012
Source: Federal Reserve and the Bureau of Labor Statistics
Note: The charts show a continuous change in the six indicators for the first 10 years after the increase in retirement age and then snapshots at years 20, 30, 40, 50 and over the long run
Debt ceiling timeline:
It will be reached at the end of November but no fiscal fiasco this time

Source: PIMCO estimates
Refer to Appendix for additional outlook information.
The Fiscal Outlook
New Year’s: Washington style
One fiscal crisis averted, another to come

SOURCE for comic: Fort Meyers Press
The good news: Fiscal cliff largely averted with only some associated fiscal drag

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Bush Tax Cuts for Upper Earners</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Income &gt;$450K for joint filers/$400K for individuals now taxed at 39.6% marginal rate</td>
<td>$60</td>
<td>Increased</td>
</tr>
<tr>
<td>• Cap gains/dividends now taxed at 20%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Estate tax now at 40% with $5MM exemption</td>
<td></td>
<td></td>
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<tr>
<td>Bush Tax Cuts for Middle Class</td>
<td>$155</td>
<td>Made permanent</td>
</tr>
<tr>
<td>• Income rates at 10%, 15%, 28%, 33% and 35%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Cap gains/dividends at 0%, 15%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AMT Patch</td>
<td>$130</td>
<td>Made permanent</td>
</tr>
<tr>
<td>2% Payroll Tax Cut</td>
<td>$120</td>
<td>Expired</td>
</tr>
<tr>
<td>Unemployment Insurance</td>
<td>$30</td>
<td>Extended</td>
</tr>
<tr>
<td>Affordable Care Act (3.8% on dividends/cap gains; 0.9% on wage income for $250k+)</td>
<td>$25</td>
<td>Implemented</td>
</tr>
<tr>
<td>Sequester</td>
<td>$110</td>
<td>Delayed for 2 months</td>
</tr>
<tr>
<td>Pro-business tax credits (R&amp;D tax credit)</td>
<td>$75</td>
<td>Extended</td>
</tr>
<tr>
<td>Doc Fix (Medicare reimbursement for physicians)</td>
<td>$15</td>
<td>Extended</td>
</tr>
<tr>
<td><strong>Estimated fiscal drag</strong></td>
<td><strong>$720 billion</strong></td>
<td><strong>$205 billion</strong></td>
</tr>
<tr>
<td><strong>Estimated fiscal drag as % of GDP</strong></td>
<td>~4.5%</td>
<td>~1.3%</td>
</tr>
</tbody>
</table>

**SOURCE:** CBO, Joint Committee on Taxation, Tax Policy Center, Congressional Research Services, Peterson Institute for International Economics, PIMCO

- President (mostly) kept his campaign promise by increasing rates on the rich and limiting deductions
- Deal made middle class tax cuts permanent, which was not unexpected but hugely expensive
- Deal did little to address spending issues and sets up for a larger fight over spending in 2013
- Majority of fiscal drag in 2013 comes from the expiration of payroll tax cut and an increase in rates on upper earners
The bad news: Debate now centers on a trifecta of imminent spending-related issues

- **Debt Ceiling**: Fiscal cliff deal did not raise the debt ceiling, which will need to be increased by March 2013 at the latest.

- **Sequester**: Fiscal cliff deal delayed sequester by only two months. If not addressed by March, discretionary spending will be subject to ~8% across-the-board cuts and defense spending subject to ~10% cuts in 2013.

- **Continuing Resolution**: U.S. government is functioning under a continuing resolution, which expires at the end of March. If not renewed, government will not be funded, leading to a government shutdown.

Unresolved issues will lead to significant uncertainty and volatility in Q1 2013, if not beyond.
Fiscal Policy: Breaking generational promises is difficult, to say the least; For the developed world, it is the transformation of a century

The Migrant Mother, 1936

Protestors at the Hellenic Parliament in Athens, Greece, June 2011

Source: U.S. Library of Congress
U.S. policymakers face enormous pressure against reducing entitlement spending – achieving a **Grand Bargain** will be difficult.

Numbers of Americans 65 and over

![Graph showing the increase in numbers of Americans 65 and over, with a note that Baby Boomers began turning 65 in 2011.](source: U.S. Census Bureau, Decennial Census)
Seniors love to vote

Source: U.S. Administration on Aging

Percentage within age groups that voted in the 2008 general election

<table>
<thead>
<tr>
<th>Age groups</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>18 to 24</td>
<td>45</td>
</tr>
<tr>
<td>25 to 34</td>
<td>55</td>
</tr>
<tr>
<td>35 to 44</td>
<td>60</td>
</tr>
<tr>
<td>45 to 54</td>
<td>67</td>
</tr>
<tr>
<td>55 to 64</td>
<td>73</td>
</tr>
<tr>
<td>65 to 74</td>
<td>77</td>
</tr>
</tbody>
</table>

Source: U.S. Administration on Aging
Entitlement spending is where the meat is

### U.S. Budget Outlays - Fiscal Year 2012

<table>
<thead>
<tr>
<th>Spending Category</th>
<th>Amount (in billions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mandatory</strong></td>
<td></td>
</tr>
<tr>
<td>Medicare</td>
<td>560</td>
</tr>
<tr>
<td>Medicaid</td>
<td>275</td>
</tr>
<tr>
<td>Social Security</td>
<td>725</td>
</tr>
<tr>
<td>Other</td>
<td>493</td>
</tr>
<tr>
<td><strong>Discretionary</strong></td>
<td></td>
</tr>
<tr>
<td>Defense</td>
<td>669</td>
</tr>
<tr>
<td>Non-defense</td>
<td>620</td>
</tr>
<tr>
<td><strong>Net interest</strong></td>
<td>220</td>
</tr>
<tr>
<td><strong>Total outlays</strong></td>
<td>3,562</td>
</tr>
</tbody>
</table>

Source: Congressional Budget Office
IMF Study:  
A simple solution with big results, but politicians have no courage

What would happen to the U.S. debt-to-GDP ratio if the U.S. raised its retirement age by 2.5 years?

As of 30 June 2012  
SOURCE: IMF
The Do-Nothing Congress

*Note: The 80th session of Congress was in 1947

SOURCE: Washington Post
U.S. debt projections – Do something!

Federal Debt Held by the Public, Historically and As Projected in CBO’s Baseline and Under an Alternative Fiscal Scenario

(Percentage of gross domestic product)

Source: Congressional Budget Office.
Main objectives and investment implications of the Fed’s activist policy regime, which is geared toward smoothing the deleveraging process:

1. Flatten the forward curve
2. Reduce interest rate volatility and therefore the term premium in bonds
3. Compel investors to move out the risk spectrum

To achieve these goals, the Fed appears confined to utilizing three tools:

I. Zero interest rates
II. Asset purchases
III. Communications strategies
The Fed: “Screaming” for investors to take risk and bid up asset prices

Babe Ruth’s 1920 road jersey
$4.4 million

Munch’s “The Scream”
$120 million

Figure 1

Source: PIMCO
Pottersville: What would the world be like if the Fed didn’t exist?
Pottersville: What would the world be like if the Fed didn’t exist?

The nine woeful elements of Irving Fisher’s debt deflation theory of depressions (1933):

1. Debt liquidation leads to distressed selling, which leads to
2. Contraction of the money supply, thereby resulting in
3. A fall in the level of prices, and
4. A still greater fall in the net worths of businesses, precipitating bankruptcies and
5. A fall in profits that lead to
6. A reduction in output, employment, and trade, all of which lead to
7. Pessimism and loss of confidence, and then
8. Money hoarding
9. All of the above then result in an increase in real interest rates
PIMCO's cash management philosophy

TIER II+
Primary objective: Grow cash balance over long-term

TIER II
Primary objective: Enhance returns to cash, daily liquidity

TIER I
Primary objective: Principal preservation, daily liquidity

PIMCO provides tiered solutions in an effort to meet client-specific needs

Refer to Appendix for additional investment strategy and risk information.
Short-term bond investors can earn a MINT…

As of 31 December 2012
SOURCE: Bloomberg, Municipal Market Advisors, and ICAP
Agencies: Agency Discount Note (composite of discount offered levels received from brokers and dealers for U.S. Agency discount notes); Treasuries (U.S. on-the-run government bill/note and bond indices); Municipals: Consolidated data provided by Municipal Market Advisors; Commercial Paper, Certificate of Deposit and Corporate are composite curves provided by Bloomberg; General Repo (consolidated data provided by ICAP).
Refer to Appendix for additional risk information.
Escaping financial repression

2012 Returns: T-Bills vs. Short-Term/Low Duration Strategies (net of fees)

As of 31 December 2012
SOURCE: PIMCO, Bloomberg
Appendix

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

RISK
All investments are subject to risk including possible loss of principle.

FORECASTS
Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, as an offer or solicitation, nor as the purchase or sale of any financial instrument. Forecasts and estimates have certain inherent limitations, and unlike an actual performance record, do not reflect actual trading, liquidity constraints, fees, and/or other costs. In addition, references to future results should not be construed as an estimate or promise of results that a client portfolio may achieve.

OUTLOOK
Statements concerning financial market trends are based on current market conditions, which will fluctuate. 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 for the long-term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.

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