PIMCO

SECULAR OUTLOOK

OCTOBER 2020

Escalating Disruption

The pandemic has amplified long-term disruptors, making credit selection and alpha generation increasingly important.

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SUMMARY

- Four macroeconomic disruptors are likely to become even more pronounced over the secular horizon: China's rise, populism, climate-related risks, and technology.
- The two key swing factors that could produce upside or downside surprises are the state of the pandemic and the degree to which fiscal policy stays active or retreats.
- Investment success over the secular horizon will likely call for actively managing portfolios both to withstand disruptors and to pursue the opportunities that disruptions create.

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PIMCO's annual Secular Forum this September was the 39th in our firm's history – and the first fully virtual one. With input from invited speakers (see sidebar) as well as our Global Advisory Board and other consultants, our global team of investment professionals zoomed (Webex-ed, actually) in on the post-pandemic outlook for the global economy, policy, politics, and financial markets over the next three to five years and discussed the implications for investors' portfolios. Here's what we concluded.

At the outset we reminded ourselves of the pre-pandemic secular framework laid out in our essay "Dealing With Disruption" in May 2019. Back then, we had anticipated *"a difficult investment environment, subject to radical uncertainty and a range of secular disruptors"* such as China's rise and the resulting geopolitical tensions, populism, deflationary demographic trends, financial vulnerabilities related to valuations and pockets of excess leverage, and technology and sustainability issues that create winners and losers.

Sadly, major disruptions and radical uncertainty indeed unfolded this year, albeit from an unexpected source – the COVID-19 pandemic that has already cost more than one million lives worldwide, caused the deepest economic recession since the Great Depression, and sparked staggering fiscal and monetary policy responses.

We concluded that the core of our "dealing with disruption" framework remains intact: We believe investment success over the secular horizon will continue to be defined by being prepared for disruptions from a variety of sources and by actively pursuing the opportunities that arise when volatility occurs. This is even more important now that markets will have to grapple with the longer-term consequences of the pandemic shock, its propagation, and the policy responses.

CYCLICAL HEALING BUT LONG-TERM SCARRING

The first half of our secular horizon is likely to be characterized by "The Long Climb" to recovery, with above-trend growth for a couple of years as the global economy emerges from the deep hole of the COVID recession. The two key swing factors that could produce upside or downside surprises are (1) the health situation – renewed infection waves versus effective vaccines and treatments – and (2) the degree to which fiscal policy stays active or retreats. While more stimulus is already on the horizon in Europe with the EU recovery fund starting to disburse funds during 2021, the outcome of the U.S. election in November will (hopefully) provide more clarity on the scope and nature of continued fiscal support.

While a continuation of the cyclical recovery over the next year or two is very likely, we think the concerns voiced by several speakers at our forum about "economic scarring" that will weigh on steady-state potential output growth are warranted. Longer spells of unemployment typically imply an erosion of individuals' skills and thus labor productivity. Also, higher uncertainty will likely depress business investment for a long time to come. Together with an increasing "zombification" of the corporate sector due to massive government and central bank support, this will likely weigh on longer-term productivity growth.

Economic scarring could weigh down long-term productivity growth.

However, we also discussed more positive longer-term growth scenarios that mostly centered on the possibility of much more active fiscal policies promoting private and public investment via infrastructure spending, stronger research and development spending as part of the new technology race, green deals, improving human capital formation via education, and tax reform. While such a "positively disruptive" scenario is not our baseline, it is an important upside risk to our more cautious baseline scenario.

Moreover, we were positively surprised by the European policy responses to the crisis, in particular the new EU recovery fund and the forceful and swift action by the European Central Bank (ECB) via its new pandemic emergency purchase program. These developments serve to underscore the time-tested refrain that European integration only progresses through crises. While we continue to expect occasional setbacks due to political risks in a range of countries, the chances have increased of a less crisis-prone euro area with further steps toward a more complete banking union and a larger joint fiscal capacity.

CRISIS AMPLIFIES FOUR SECULAR DISRUPTORS

Zooming in on potential disruptions, we concluded that several of the trends that we identified as disruptive in the past are likely to become even more pronounced over the secular horizon:

China's rise as an economic power that disrupts higher-value-added producers elsewhere in the world and challenges the established geopolitical order dominated by the U.S. is likely to be accelerated by its earlier and stronger rebound from the COVID crisis and its strengthened focus on its strategic plan, which was recently rebranded from "Made in China 2025" to a "dual circulation strategy" focused on cutting its dependence on global markets and technology, while remaining open to international markets (see "Assessing China's 'Structural' Monetary Policy").

Populism and its close cousins protectionism and nationalism are likely to be fortified by the pandemic recession and its impact on rising inequality along several dimensions, which was one of the focal points of our discussions. Against this background, we considered but eventually dismissed the thesis that we have already seen "peak populism" around the world.

Climate-related risks and their impact on human lives and economic activity became even more apparent and acute this year, focusing attention on "fat tail" catastrophic environmental events. Apart from these physical risks, transition risks related to the move to a greener economy are an increasing focus for policymakers, companies, and investors – as also highlighted by Mark Carney, one of our forum guest speakers and the latest addition to PIMCO's Global Advisory Board, who referred to the risk of a climate "Minsky moment" (i.e., collapse in asset prices, building on the phrase coined by former PIMCO chief economist Paul McCulley). Moreover, as we already emphasized last year, investors will have to factor in additional government responses to climate and other environmental risks in the form of regulation, corporate reporting requirements, carbon taxes, and public investment, including the explicit green focus in the large new EU recovery fund. These are now mainstream issues and, depending on the policy choices, will likely affect fiscal policy, private sector decisions, capital flows, and asset prices over the secular horizon. With many winners and losers in the corporate sector, these trends call for active management of credit and default risks.

Technology's role as a beneficial yet also disruptive force has been amplified by the COVID-19 crisis. While work and consumption patterns are likely to revert some way toward pre-crisis levels once the pandemic recedes, the additional economic prowess of established and new technology companies gained during the crisis will make them an even stronger disruptive force. Successfully distinguishing the winners and losers from digitalization will be an important source of alpha for active investors over the secular horizon.

MONETARY POLICY: TRAPPED

Given the difficult near-term and longer-term economic backdrop, and with disruption likely to lead to repeated bouts of volatility in financial markets, we expect monetary policy rates in most advanced economies to stay low or go even lower for much or all of the next three to five years. We view negative rates as a desperate tool with adverse side effects that become larger the longer rates stay negative (see "A Negative View on Negative Rates"). However, with bond yields already low or negative and yield curves flat, more central banks are likely to venture into negative (or more deeply negative) territory in response to future adverse shocks, along with further purchases across a wide spectrum of financial assets.

The Federal Reserve's move to flexible average inflation targeting (FAIT) was also a topic of debate. We concluded that, based on the Bank of Japan's experience with its overshooting commitment adopted in 2016, this may well remain an aspirational goal for a long time, especially as the Fed's commitment to actually overshoot seems rather lukewarm so far and there appears to be a lack of consensus among Fed leadership (see "The Fed's New Guidance: Surprising Is Not Convincing"). While central banks including the Fed have the means to provide a backstop for asset markets in times of crisis, credibly achieving their inflation targets requires a tool they cannot control: fiscal policy.

FISCAL POLICY HOLDS THE KEY

The unprecedented global fiscal response to the crisis, facilitated by massively expanded central bank purchases of government bonds, has opened up a much wider range of possible secular scenarios for fiscal policies around the globe.

On one end of the spectrum of possible outcomes, fiscal stimulus during the crisis would remain a one-off followed by a return to passive or restrictive policies caused by political gridlock or a renaissance of deliberate austerity policies. Thus the current weak form of fiscal dominance, where monetization is in the interest of both the government and the central banks, remains an episode. In this scenario, inflation and inflation expectations remain low or drift even lower and central banks on their own are not able to engineer on-target or above-target inflation.

We expect policy rates in most advanced economies to stay low or go even lower.

In an opposite scenario we discussed, as the economy returns to normal fiscal policy stays expansionary or becomes more active, for example by focusing on additional spending programs to address inequality, infrastructure needs, and green projects. In this scenario, weak fiscal dominance turns into a hard form of fiscal dominance as monetary policy is coerced into keeping rates low and monetizing deficits even as inflation eventually takes off.

While the likely fiscal path in most major economies probably lies somewhere in between, each of the extreme scenarios now seems somewhat more likely than before the pandemic shocked governments out of their respective fiscal comfort zones. As a consequence, we believe the inflation tail scenarios have increased – that is, both deflation and high inflation outcomes driven by different fiscal policies have become more likely.

Investment conclusions

The purpose of the Secular Forum is to identify risks and opportunities, to anticipate long-term trends, and to establish guardrails for our portfolios and priorities as risk managers.

THE REALITY OF A LOW-RETURN ENVIRONMENT

What is clear, in spite of ongoing favorable asset market returns this year – during a period of crisis – is that the outlook for asset market returns over the next three to five years is likely to be different from the experience of the past decade. Starting valuations in bond markets and equity markets make it very difficult to envision the ongoing inflation of asset prices as the byproduct or the intention of policy interventions, including with the best efforts of central banks to offset the effects of future negative shocks. Given historically low yields and high equity valuations, it makes sense for portfolio managers and asset allocators alike to lower their return expectations rather than stretch too far and extend too far down the quality spectrum in hope of maintaining historical levels of returns. There is no shortage of examples from history where investors experienced multiyear periods of flat investment returns, or worse. The experience of the past 10 years is not necessarily the guide for the next decade.

We anticipate a broadly range-bound environment for government bond yields will be maintained for much or all of the next three to five years. Central bank policy rates are unlikely to rise for a long period and there is some risk of a shift lower. We see both downside risks to yields in the event of a broad shift toward negative policy rates and upside risks if the monetary and fiscal efforts lead to a sustained rise in inflation expectations. Indeed, while we see very little upside risk to inflation in the near term, we think that over time it will make sense to hedge against a rise in inflation using Treasury Inflation-Protected Securities (TIPS), yield curve strategies, real estate, and potentially exposure to commodities.

The low yield environment and reach for investment returns may continue to support equity markets. But starting valuations should dim any excessive optimism. Indeed, the long-term history in Japan over decades and the shorter experience in Europe over the past few years show that there is no guarantee of outsized gains for equities over bonds, even in a very low yield environment.

In a period of weak economic activity, we see the potential for the secular rise in profits as a share of GDP to stall or reverse. This could be the result of shifting political and corporate objectives, of re-regulation, or of increased taxation of capital – with the U.S. election an important and immediate harbinger.

2020 Secular Forum Guest Speakers

Jason Bordoff
Founding Director, Center on Global Energy Policy; Professor of Professional Practice in International and Public Affairs, Columbia University

Mark Carney
UN Special Envoy on Climate Action and Finance; Finance Advisor for the U.K. presidency of the COP26; former Governor of the Bank of England (2013–2020), former Governor of the Bank of Canada (2008–2013); former Chair of the Financial Stability Board (2011–2018)

Mario Draghi
Former President of the European Central Bank (2011–2019)

Jim Messina
Former U.S. Deputy Chief of Staff in the White House (2009–2011); former Campaign Manager for President Barack Obama (2012)

Michael Murphy
Former senior strategist for John McCain, Mitt Romney, Jeb Bush, and Arnold Schwarzenegger

Condoleezza Rice
66th U.S. Secretary of State; Incoming Director, Hoover Institution; U.S. National Security Advisor (2001–2005)

Christina Romer
Professor of Economics, University of California, Berkeley; former Chair, U.S. Council of Economic Advisors (2008–2010)

We also see risks related to de-globalization and shifts as the result of environment pressures that may lead to stranded assets for the companies that are exposed. ESG (environmental, social, and governance) considerations are increasingly important to our clients, and assessing the impact and importance of these factors is and has long been a core part of our investment process.

OPPORTUNITIES IN CREDIT

Credit spreads are close to their tights, but we will seek to add value with active name and security selection.

In March 2020, central banks provided a backstop that eased credit market dislocation during a period of extreme market illiquidity. However, central banks will not protect investors against rising default risk, which in a period of prolonged COVID-related suppression of activity could disproportionately affect certain sectors and issuers. This is not an environment where we want exposure to generic credit, but one where we want to make full use of our global team of credit portfolio managers and research analysts.

We continue to see U.S. agency mortgage-backed securities as a relatively stable and defensive source of income in our portfolios. In addition, U.S. non-agency mortgages and the broader set of U.S. and global asset-backed securities offer seniority in the capital structure and a favorable downside risk profile in the event of negative macro or market surprises.

Private credit and private real estate strategies offer the potential for attractive returns including harvesting illiquidity premia for investors who are able to commit long-term capital and bear the heightened risks associated with private investments.

GLOBAL OPPORTUNITIES

We expect to find good investment opportunities in Europe if the current greater stability of the euro area is maintained or – as active investors – in the event that Europe continues the more familiar pattern of one step forward followed by two steps backward. A key source of uncertainty is whether the less politicized monetary policy and more cooperation on the fiscal front that we observed at the height of the COVID shock will endure in the face of more country-specific shocks and challenges.

We also expect to find good investment opportunities in Asia, a region that thus far has demonstrated somewhat greater stability during the COVID crisis, including active opportunities for corporate credit selection.

We believe emerging markets generally offer the potential for higher returns than developed countries, given initial valuations, but also the potential for yet more significant disruptions that will lead to a range of winners and losers.

We see active management as essential to navigating credit risk.

In emerging markets, as with corporate credit, we strongly believe that active management is not a luxury but a necessity, as we seek out compelling return opportunities while managing risks to client portfolios.

With central bank policy rates at or close to what is likely to be their lowest levels, and significant uncertainty in both the short and the medium term over fiscal policy, we expect that exchange rates will serve as relief valves and shock absorbers. We anticipate an environment of higher volatility in currency markets and will look to take advantage of the opportunities created here, subject to prudent scaling.

Based on initial valuations, we do not anticipate any major secular trends in developed currency markets. The short-term cyclical outlook for a global recovery from the COVID shock raises the possibility of further U.S. dollar weakening ahead. But repeated disruptions over the secular time frame are likely to lead to periods of flight to the dollar, which many investors believe remains the safest haven even in a more multipolar world.

Emerging market currencies, as with emerging market bonds, offer the potential for higher returns given initial valuations but again are subject to local and global disruption risk.

BAD NEWS MAY INDEED BE BAD NEWS

As well as this secular period being, with high probability, a period of lower investment returns, it is also likely to be a period of higher volatility of those returns. We as investors need to be prepared.

In the earlier part of the secular horizon, uncertainties over the course of the pandemic and the shape of the recovery raise the prospect of higher economic and market volatility. While central banks will no doubt work very hard, it is not clear that they will be able to maintain their roles as volatility suppressors in chief.

We see little reason to be confident that the pattern we have observed in the past 10 years of "bad news is good news" – where markets anticipated central bank responses that dominated macroeconomic realities – will continue. Over the next three to five years it is quite likely that bad news on the macroeconomic front will turn out to be bad news for risk assets.

While it is not possible to forecast the longer-term outlook with anything approaching certainty, we see the risk of fatter tails to the probability distribution in what may be a period of ongoing experimentation in both monetary and fiscal policy. Indeed, uncertainty over the longer-term impact of the shift in the balance of monetary and fiscal policy gives rise to a broad range of potential macro and market outcomes over time and across countries.

The prospect of a more difficult investment environment and the potential for a rise in economic and market volatility mean that we will put significant emphasis on capital preservation and avoiding the risk of exposure to absolute losses. We also think this is likely to be an investment environment that calls for a patient approach, a global approach, and a flexible approach to utilize as wide as possible a set of investment instruments and pursue attractive risk-adjusted opportunities across jurisdictions.

A lower return environment means that alpha is likely to be an even more important part of total return. Active managers who can reliably add alpha to returns over the cycle can help clients navigate a more difficult investment environment. At PIMCO, we will work hard, deploying all of our global resources and specialist expertise across sectors, to generate alpha, manage risk, and assist our clients as we all continue to deal with disruption.

About Our Forums

Honed over nearly 50 years and tested in virtually every market environment, 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 to discuss and debate the state of the global markets and economy and identify the trends that we believe will have important investment implications.

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. Because we believe diverse ideas produce better investment results, we invite distinguished guest speakers – Nobel laureate economists, policymakers, investors, and historians – who bring valuable, multidimensional perspectives to our discussions. We also welcome the active participation of the PIMCO Global Advisory Board, a team of 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.

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CMR2020-0930-1349088

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