

## INTRODUCTION



# A SECULAR FIXED INCOME OUTLOOK

With the global economy perched on a tightrope, major long-term portfolio risks must be highlighted

*Circus Game*

*I'm up on a tight-wire*

*One side's ice and one is fire*

*It's a circus game with you and me*

– "Tight Rope" by Leon Russell

**P**IMCO, as the fixed income manager of Allianz Dresdner Asset Management (ADAM), believes that secular economic, social and political trends exert the most powerful and sustained influences on bond markets. We define "secular" as lasting for the next three to five years. Our secular outlook guides the way we structure portfolios in terms of duration, yield curve positioning, sector exposure, credit quality and other risk measures. ADAM refines its secular view regarding the fixed income market at PIMCO's annual Secular Forum, during which our investment professionals from around the world gather in Newport Beach, California, for three days of discussion and debate about the global economy and financial markets. We invite outside speakers – experts in economics, finance, history and politics – to supplement our internal analysis. The following is a summary of our 2004 Secular Outlook.

## » FIRE AND ICE

The global economy, propped up for the last several years by cheap money and a government and consumer borrowing binge in the US, is perched on a tightrope. Deflation (ice) and inflation (fire) are on either side of the wire. In this leveraged world, conditions for instability that could tip the walker in one direction or the other will accelerate over the next three to five years. Momentum swings will supplant the more durable economic trends witnessed during recent periods of disinflation (1980-2000) or inflation (1965-1979). US real growth will stabilise at approximately 2 per cent over this period with Europe and Japan near that level. The benchmark 10-year Treasury

yield looks fairly valued for now but could climb to around 6.0-6.5 per cent should the economy tip toward inflation, which is more likely than a move toward deflation. More inflation and higher rates could, however, produce a reversal in growth and rates later in our secular time frame.

## » RISKS

These are risks that could tilt the wirewalker in one direction or another:

● **More Government, More Inflation** – Emphasis on the private sector in 1980-2000 promoted disinflation, but history suggests that as government spending climbs as a share of GDP, inflation and interest rates tend to rise. Early



**'More inflation and higher rates could produce a reversal in growth and rates later in our secular time frame'**

**Scott Mather, ADAM**

indicators of a coming bull market in government are: large fiscal deficits, litigation across the securities industry, implementation of Sarbanes-Oxley over the entire corporate sector; imposition of steel and lumber tariffs, higher military spending to combat terrorism and Homeland Security measures.

● **Policy Mistakes** – A leveraged US economy is vulnerable to policy mistakes by a Federal Reserve that is no longer proactive in battling inflation but reactive to economic data. Leaving rates too low for too long may have fuelled inflation and created bubbles in housing, stocks and bonds, but raising them too quickly would eventually force a painful retrenchment by the overextended US consumer.

● **Imbalances In Trade and Finance** – Asian central banks provide much of the financing for the US fiscal and trade deficits. To date, playing banker to the US has suited China and Japan's political agenda, which is to keep their currencies cheap to support internal growth. A change in China's agenda sparked, for example, by a geopolitical shock over North Korea or Taiwan would mean a pullback in their purchases of Treasuries, higher interest rates and a plunge in the dollar.

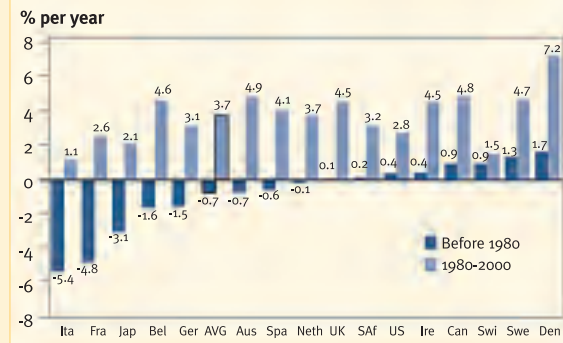
● **Geopolitical Risks** – America is stretched geopolitically as well as financially. A seemingly endless struggle against terrorism worldwide, accompanied by constraints on travel and trade, will be a persistent threat to consumer confidence and spending.

## » IMPLICATIONS

● **Mildly Bearish On US Bonds** – Chart 1 points out that it was only during the post-1980 disinflationary period that short-term real interest rates were abnormally high on a global basis. Reflationary, government oriented periods have much lower real rates averaging – believe it or not – a negative 0.7 per cent globally for the first 80 years of the 20th century. We believe that 1 per cent real short rates are about all the US and global economy can take given its leverage and potential for tipping into deflationary ice. If so, front end to intermediate term yields may be close to fair value given a future 3 per cent Fed Funds level in the US and a 2 per cent rate in Euroland.

Whether or not we continue to stay here will depend on inflationary trends, which for now point upward. In general, we are therefore mildly bearish on US bonds, and more neutral towards global alternatives.

Real interest rates internationally pre- and post-1980



Source: *Triumph of the Optimists*, Princeton University Press

● **Diversify With Euroland Bonds** – Euroland will move in the opposite direction from the US. Smaller fiscal deficits and modest efforts at deregulation point to less government involvement in these economies, though admittedly from a higher base. It makes sense to purchase bonds of governments where the inflationary bias and upward pressure on rates will be more muted. Continued dollar weakness arising from the US trade deficit will add to the appeal of non-US bonds because of the inflationary implications of a weak dollar in the US.

● **TIPS For Insurance** – Treasury Inflation Protected Securities are at fair value after their strong rally over the past year. Even so, they remain an effective hedge against a potential surge in inflation.

## » HOW TO BENEFIT?

ADAM's European flagship fund – the dit-Euro Bond Total Return – is most able to benefit from these opportunities as it has the greatest flexibility to take advantage of these secular events. For example, over the last half-year we positioned the dit-Euro Bond Total Return fund to take advantage of the expected higher reflationary forces within the US. This strategy, driven by our secular analysis and remains within the fund today, helped contribute to our outperformance over the last year. The fund is unique in that we can implement the best risk-adjusted opportunities derived from our secular forums as well as additional analysis within this fund, while maintaining a Eurozone bond fund risk profile and using the Lehman Euro Aggregate Bond index as our benchmark. Long-term we think that this is a successful combination.

*Scott Mather, head of European fixed income portfolio management, Allianz Dresdner Asset Management*

## » CORPORATE STATEMENT

Allianz Dresdner Asset Management (ADAM) is a unique global network of investment management brands within Allianz Group. With global investment platforms (eg, PIMCO representing bond management and RCM representing equity management) and local distribution platforms in the key financial markets, ADAM manages more than one thousand billion euros. Germany-based investment company Deutscher Investment Trust (dit) is one of ADAM's European mutual fund business units. Dit manages and distributes nearly 200 open-ended funds.

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