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PIMCO's Inflation Outlook and Investment Implications (April 2010)

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by Mihir Worah, Portfolio Manager and Managing Director, PIMCO, April 2010.

The continued fiscal worries of a number of economies within the eurozone and the uneven global growth trajectory have created more uncertainty around inflation forecasts than usual. Mihir Worah, managing director and head of the Real Return portfolio management team, discusses PIMCO's outlook and examines whether inflation or deflation poses a more imminent threat for investors.

Q: PIMCO said that it sees disinflation over the cyclical horizon but expects inflation over the secular horizon of the next three to five years. Has this outlook changed?

Worah: No. This outlook has not changed. However, uncertainties around this have increased rather than decreased. We continue to expect mild or slowing inflation over the next one to two years. The slowdown in the economy and the concurrent dip in resource utilization are two major reasons for this forecast. However, we now have a new disinflationary factor thrown into the mix with the lack of appetite for fiscal stimulus injections from governments, including the U.S. and U.K., which are facing mounting fiscal pressure. To reflect this view, our inflation-linked bond portfolios are currently positioned to be underweight inflation-linked bonds as a tactical trading position.

In the longer term, we continue to expect higher and more volatile inflation than was typical in the past. There are several reasons for this, one of which is a secular decline in developed market currencies versus emerging currencies and related to that, an increase in commodity prices. We will address the issue of commodities specifically later. In addition, we expect the capacity destruction that we have seen in whole economies to play a role here. With entire sectors of the economy and many human skill sets becoming obsolete, we will find capacity constraints as economies start to recover, leading to the possibility of higher inflation. Finally, there is the possibility of policy error or political intervention, which may prevent central banks from shrinking their balance sheets in a timely fashion. All of these factors point to the possibility of higher inflation further down the road.

Q: In 2009, central bank measures such as quantitative easing programs and keeping interest rates low seemed to have helped stabilize markets and fight deflation threats. But with such programs nearing expiration, which will pose a bigger threat – deflation or inflation?

Worah: As you suggest, the quantitative easing programs were a key tool in combating financial instability and the possibility of deflation after the events in the fourth quarter of 2008. Therefore, to the extent that central banks discontinue their quantitative easing programs, I would say there is a near-term risk of flipping to deflation given our view that developed economies have not fully healed and consumers are not yet ready to stand on their own two feet. And to the extent central banks continue their quantitative easing programs then clearly they are once again truncating the deflationary tail and we can anticipate a successful reflation of the economy. But any meaningful inflation should still be a couple of years away.

Q: How do bloated balance sheets of central banks, many of which reached unprecedented levels in 2009, affect inflation?

Worah: Essentially the bloated balance sheets of central banks affect inflation in two ways. The first is the way in which the money moves out of the banks' balance sheets and into the broader economy, which is not occurring yet. And when it does start to get there, there's still about a two- to three-year interval between this greater money supply in the broader economy and inflation. So what these bloated balance sheets have done is simply truncate the deflation risk in some countries, which featured highly about a year ago in countries like the U.S. and U.K. In the longer term, the risk these bloated balance sheets pose for inflation is really by way of political interference. Central banks know

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what they need to do to unwind their balance sheets in a timely fashion once credit conditions normalize in order to control inflation. However, if they have their independence encroached upon or curtailed by political institutions, this could certainly raise inflation risk in the longer term.

Q: Will rising sovereign risk, especially within the eurozone, create inflation or indeed deflation risk?

Worah: The answer to this depends on the timeframe and on the country in question. In general, there are essentially three ways out for countries that cannot service their debt: The first is to grow their way out of it, the second is to default on their debt, and the third is to inflate their way out of it. Which option is selected is really country- and region-specific.

Countries such as the U.K. and the U.S., which have their own fiscal issues, clearly aren't going to default on their debt. They issue debt in their own currency and control their own monetary policy. Hence, in the longer term, inflation is a likely solution to deal with their inability to grow their way out of persistent deficits. However, in the eurozone, you're faced with a very different situation where countries like Greece cannot issue debt in their own currency. They cannot debase their currency, which makes their economy more competitive, and so it is unlikely that they can grow their way out of it. So the only possible outcome (other than an outright default) is fiscal belt-tightening and reduction of input (labor costs) in order to make the goods and services they produce more competitive – and this is deflationary. We are already seeing signs of this. Countries in Europe with the worst fiscal situations that have started the tightening process, like Ireland and Spain, are already showing strong signs of deflation and we expect to see deflation in Greece as well.

To summarize, countries that cannot grow their way out of the problem and do not have their own currency that they can debase are more likely to see deflation. Meanwhile, you should expect to see the opposite effect in countries like the U.S. and U.K., which issue debt in their own currencies.

Q: To what extent have the highly differentiated fiscal situations of countries influenced PIMCO's inflation outlook across regions?

Worah: We have already discussed some of the relevant issues. The current focus on the creditworthiness of sovereigns leads to important differentiations in our outlook not just for inflation but for real yields and investment returns in the various countries. You can no longer adopt a one-size-fits-all or an "old normal" approach to investing. Investors should shed local biases if investing offshore offers better return on capital as well as less risky and more likely return of capital. For example, you have to differentiate not just between fiscal situations of different countries but also between countries that control their own printing press and those that do not.

For countries with strong fiscal situations, like Canada and Germany, inflation is not really an issue. In other countries like Greece, Spain and Ireland, you're likely to see deflation. And with countries like the U.S. and U.K., which don't have a strong balance sheet but have a printing press, there is likely to be higher inflation. So there's a degree of differentiation in our inflationary outlook.

In addition to differentiated outlooks on inflation, investors will likely demand higher real rates of return to lend money to the high fiscal deficit countries that need to repeatedly tap the capital markets to finance their operations. This leads to the possibility of capital losses for investors in certain countries. Bottom line, we think it is important that investors shed strict local biases and allow for tactical country rotation within their portfolios, including their inflation-linked bond portfolios, in this evolving and heterogeneous environment.

Q: What is your outlook for commodity prices over the next 12 months versus the next five years and the effect this will have on inflation?

Worah: Over the next 12 months we have a fairly benign outlook on commodity prices. We think most commodities are trading at, or close to, fair price or within marginal cost of production. Inventories are at the high end of historical levels so we do not expect much pricing pressure from commodities over the next 12 months. This forecast is in line with our expectation for slower economic growth, which will further discourage pricing pressure over the next 12 months. But the longer-term story, characterized by a mismatch between supply and demand, remains unchanged. Demand continues to grow, especially from emerging economies such as China and India, and we continue to have a hard time sourcing alternatives to several key commodities.

As the unfortunate events in Chile recently pointed out, commodities, just like inflation-linked bonds, can act as a good tail risk hedge or option. While an earthquake in Chile does not necessarily affect global financial markets much, it can take 10% off the world's copper supply! As a result, we saw an immediate 5% spike in copper prices as soon as the news of the earthquake began making the headlines. So there could be events or geopolitical risk (in regions like the Middle East) that would warrant a measured allocation to commodities, but in the absence of such events and geopolitical risks, we do not see near-term pricing pressure on commodities. However, in the longer term, we expect commodity prices to be higher for the reasons cited before.

Finally, this is a juncture where we should be thinking the unthinkable – if every country tries to debase its currency in order to remain competitive, then the only assets with value are the “real” ones. Hence, a modest allocation to commodities is warranted independent of one’s view on the near term or the direction in which commodity prices may be moving.

Q: How should investors adjust their inflation protection strategies in line with the potential headwinds?

Worah: In the last six months, we have been advising clients to adjust their portfolios along the lines of what I have said so far: We do not think inflation will be a concern for another year or so, suggesting little need to rush into an allocation. However, as a hedge against event, sovereign and commodity price risks, as well as a portfolio diversification tool, an allocation to inflation-linked bonds and commodities may make sense. Investors should take advantage of price disruptions to start building their strategic positions to hedge against future inflation. In fact, there have already been signs the market may be coming round to this point of view (little inflation concern over the next 12 months or so) when inflation-linked bonds underperformed quite significantly in the first two months of 2010. Investors may wish to take advantage of this weakness and begin scaling into a position in inflation-linked bonds.

Q: Is it more prudent for European investors to invest in U.S. Treasury Inflation-Protected Securities (TIPS), global inflation-linked bonds (ILBs) or to stay closer to home when considering inflation-linked bonds?

Worah: An extremely important question. It used to be that inflation and interest rate cycles were highly correlated across all developed economies. In such an environment it did not make much difference whether one invested in the domestic ILB market or in a global basket of linkers. The global basket opened up a greater opportunity set for active management, but a long-term passive investor would be indifferent when choosing between the two. This is no longer the case. In the medium term, and possibly even longer term, inflation dynamics and interest rate levels are likely to be widely differentiated between countries depending on the initial conditions of the country in question. The opportunity to add alpha, and more importantly to avoid capital losses, is higher for the skilled active investor. The passive investor should consider hewing closer to the home country. To stress, if investors want to take advantage of this differentiation to boost their potential returns and avoid potential losses, and if they are comfortable with some modest risk taking, they should seek out skilled active managers. As I mentioned earlier, this differentiation and real rate dynamics mean that tactical country rotation will likely be important to preserving investor capital and adding value versus indexes. Investors who are more risk averse and prefer the passive route should stay closer to home.

Thanks, Mihir.