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SCALING IT BACK

Joachim Fels & Andrew Balls

With her speech entitled "From Adding Accommodation to Scaling It Back" on 3 March 2017, U.S. Federal Reserve Chair Janet Yellen not only cemented market expectations for the Fed's third rate hike in this cycle, subsequently implemented in the Ides of March. She also unintentionally provided what turned out to be the leitmotif of PIMCO's March 2017 Cyclical Forum – scaling it back. We found ourselves applying the concept to not just the monetary policy outlook but to a range of developments across the global economy.

Aided by the participation of our Global Advisory Board consisting of its chairman Ben Bernanke, Gordon Brown, Ng Kok Song, Anne-Marie Slaughter and Jean-Claude Trichet, and informed by our macro team's scenario analysis and our regional portfolio committees' presentations, PIMCO's investment professionals debated whether our 2017 cyclical (six- to 12-month) narrative of radical uncertainty and fatter tails from last December (see "Into the Unknown") was still intact. Our conclusion: Yes, but.

Given the continuing lack of detail on the Trump administration's fiscal and trade policies, the lingering uncertainty about the upcoming elections in France, Germany and potentially Italy, and the risks associated with China's debt bubble and capital outflow pressures, we reconfirmed our "Stable But Not Secure" secular (three- to five-year) framework and generally also our "fatter tails" cyclical outlook. ("Fatter tails" refers to the distribution curve of potential outcomes in which we see a generally lower-than-usual probability of the central or baseline scenario coming to pass and correspondingly higher probabilities of the tail-risk scenarios, both to the downside, or left tail, and to the upside, or right tail.) However, given what we learned in the three months since our December forum, our cyclical story has become slightly more nuanced in several ways. Here's how and why:

First, we scaled back the expected size of fiscal stimulus in the U.S. and now anticipate a fiscal package to be finalized in Congress only in early 2018 – thus its impact would occur beyond our cyclical horizon. Repealing and replacing Obamacare will keep Congress busy for a while, and comprehensive tax reform will take time and is hard to do given the rising opposition to the border adjustment tax from the adversely affected importing industries and in the Senate. Thus, any fiscal boost is likely to be smaller and come later. Viewed in isolation, this somewhat reduces the probability of a right-tail (positive) outcome for economic growth, at least over our cyclical horizon, even though expectations of an eventual fiscal package should continue to support consumer and business sentiment.

Second, it also seems appropriate to scale back the left-tail risk of a full-blown trade war sparked by aggressive U.S. trade policy changes. To be sure, the rhetoric coming out of the administration on trade continues to be antagonistic. However, the reported debate within the White House between moderate "globalists" and more aggressive "nationalists" suggests that the rhetoric shouldn't be taken at face value. It would have been easy for the Trump administration to impose trade sanctions early on via executive orders. The fact that this hasn't happened even though the trade hawks were already operating in the White House early on in this administration while the more moderate voices were still awaiting congressional confirmation suggests that President Trump's statements on tariffs may be more symbolic than real. To be sure, this was our base case all along, but the left tail of a ferocious trade war looks less likely now.

Third, and partly related to the previous item, we are scaling down the risk of a major China "accident" this year. Both our internal and external experts at the forum emphasized the will and the wherewithal of the Chinese leadership and central bank to maintain financial and (relative) exchange rate stability ahead of the 19th National Party Congress in the fourth quarter of this year. While capital outflow pressure and rising debt pose serious risks over the secular horizon, the cyclical outlook for China appears to be for relative stability. Note, however, that the lowered official growth target of around 6.5% for 2017 and the heightened focus of the authorities on financial stability imply a waning of the Chinese credit impulse for the global economy in the course of this year.

The quote

We expect to be neutral on overall equity risk in our asset allocation portfolios.

Fourth, recent polls as well as the outcome of the Dutch election last week suggest somewhat lower odds of success for nationalist, anti-European candidates and parties in the upcoming elections in France and Germany. In fact, as we discussed at the Forum, the momentum for Emmanuel Macron in France and Martin Schulz in Germany increases the probability of a "more rather than less Europe" outcome, which could benefit assets in the peripheral countries. Overall, however, we remain cautious on Europe given the near-term political event risk and also our secular concerns about the viability of the euro in its present form, as redenomination risk – albeit very remote – has resurfaced in the eurozone.

Fifth, we are scaling back our assessment of near-term inflationary pressures in the U.S. following the recent run-up in headline inflation (which we had anticipated). One reason is that labor force participation has increased in recent months, which is likely to damp wage inflation for now. Another reason is that oil prices have recently declined in response to fears of an expiration of last year's OPEC deal on supply constraint just at a time when more U.S. shale supply is coming to the market. To be sure, we think longer-term risks to inflation are skewed to the upside, but at the same time the momentum behind the recent reflation trade is likely to ebb temporarily in the near term.

A strengthening and broadening global expansion

Putting it all together, we are now more confident in our baseline view that the nearly eight-year-old global economic expansion will be strengthening and broadening over our cyclical horizon. In fact, both world GDP growth and consumer price inflation for 2017 are now likely to come in a quarter percentage point higher than previously expected, reflecting: 1) generally supportive fiscal policies (or expectations thereof) in most developed market economies, 2) easier financial conditions since the start of the year, 3) more positive animal spirits as evidenced by consumer and business confidence data and 4) a rebound in global trade in recent months. While back in December we forecast 2017 world GDP growth averaging 2.5%–3.0%, we now expect growth to be in a 2.75%–3.25% range this year, up from 2.6% in 2016. More specifically (and also see the forecast table), here are our baseline scenario estimates for growth and inflation in major economies around the world in 2017:

- We expect U.S. GDP to grow in an above-trend 2%–2.5% channel through 2017 as business investment recovers, particularly in the energy sector, and consumer spending is supported by a further decline in unemployment, higher consumer confidence and expectations of personal income tax cuts in 2018. Meanwhile, we forecast core inflation to hover sideways this year, but that the Fed will feel encouraged by above-trend growth to raise interest rates two more times during 2017 on top of the March rate hike. Also, we expect the Federal Open Market Committee to discuss and eventually agree on a plan to taper reinvestment of maturing bonds starting in 2018 and thus organically shrink the Fed's balance sheet.
- We now expect the eurozone economy to grow in a 1.5%–2% range in 2017, revised higher from our December forecast to reflect the stronger momentum into the year. While political uncertainty remains elevated ahead of crucial elections in France, Germany and potentially Italy, both fiscal policy and monetary policy are expansionary and the recovery in global trade growth supports exports and investment. We anticipate core inflation at just below 1%, making little headway toward the European Central Bank's (ECB) "below but close to 2%" objective and that the ECB will keep buying bonds at the recently announced reduced pace of €60 billion per month through December 2017, before tapering and eventually ending its purchases from early next year.
- In the UK, we forecast growth to stay in a 1.75%–2.25% range in 2017 (above market consensus) despite Brexit, reflecting robust momentum so far and supported by higher government spending and a positive contribution of net trade on the back of the 15% fall in the pound in 2016. We forecast CPI inflation to exceed the Bank of England's 2% target, but that the Bank will keep policy rates unchanged throughout 2017.
- Japan's fiscal stimulus and a weaker yen will likely propel 2017 GDP growth into a 0.75%–1.25% zone while inflation remains subdued significantly below the 2% target. We expect the Bank of Japan to keep targeting the overnight rate at –0.1% and the 10-year bond yield at 0% and thus continue its standing invitation to the government to engage in additional fiscal expansion, which we expect to happen later this year.
- China's public sector credit bubble and its private sector capital outflows will likely remain under control this year, and we anticipate growth will slow into a 6%–6.5% band in 2017 as policymakers prioritize financial stability over economic stimulus ahead of the 19th National Party Congress in the fourth quarter of 2017. Any trade war with the U.S. will likely be engaged via words (and tweets) rather than action, and we expect the yuan to depreciate gradually by some 4%–5% against the U.S. dollar.
- In emerging markets, we expect Brazil and Russia will see moderate growth returning as their deep recessions end. With inflation dropping from elevated levels, both countries' central banks can cut rates multiple times. Meanwhile, Mexico's Banxico will likely tighten policy further (following the Fed's lead) to support the peso and quell inflation. As a consequence, growth in Mexico will likely slow into a 1.25%–1.75% band in 2017.

	Real GDP growth (% YOY)			CPI inflation (% YOY)		
	2015	2016	2017 forecast	2015	2016	2017 forecast
DM	2.1	1.6	1.75-2.25	0.2	0.8	1.75-2.25
U.S.	2.6	1.6	2.0-2.5	0.1	1.3	2.0-2.5
Eurozone	2.0	1.7	1.5-2.0	0.0	0.2	1.25-1.75
UK	2.2	1.8	1.75-2.25	0.0	0.7	2.5-3.0
Japan	1.2	1.0	0.75-1.25	0.8	-0.1	0.25-0.75
EM	4.7	4.8	5.0-5.5	3.8	3.5	3.0-3.5
China	6.9	6.7	6.0-6.5	1.4	2.0	2.25-2.75
Brazil	-3.8	-3.6	0.5-1.5	9.0	8.8	4.0-5.0
Russia	-2.8	-0.2	0.75-1.75	15.6	7.1	4.0-5.0
India	7.2	6.9	7.0-8.0	5.9	4.9	4.0-5.0
Mexico	2.6	2.3	1.25-1.75	2.7	2.8	5.0-5.5
World	3.0	2.6	2.75-3.25	1.3	1.7	2.25-2.75

Scaling back accommodation

But here is the catch, and it's a big one: With improved growth and inflation prospects, exhausted central banks are likely to move closer to the exit from ultra-accommodative monetary policies. And it's not certain whether highly leveraged private and public borrowers around the world will be able to keep dancing when the music stops.

As we learned in recent weeks, Janet Yellen and her colleagues at the Fed are now more confident that the time for "scaling it back" has come. The Fed will likely hike its policy rate twice more in the remainder of this year and looks set to allow assets to roll off its balance sheet gradually in 2018 by tapering reinvestment. Moreover, the likely replacement of almost the entire Board of Governors (including the chair and vice chair) over the next year and the potential for fiscal expansion at a time of full employment raises the uncertainty about the Fed's future monetary policy reaction function (i.e., its targeted "if-this-then-that" response to new economic data and conditions – a function that itself can change over time along with the Fed's policy approach).

In Europe, we expect the ECB to change its forward guidance on policy rates around midyear and to scale back its asset purchases further starting in early 2018, which raises the specter of sharp adjustments in euro area sovereign yield levels and peripheral sovereign spreads over Bunds.

One final note, and as mentioned earlier, with the Chinese authorities' focus shifting from growth to stability, the strong Chinese credit impulse that supported global reflation in 2016 and into 2017 is likely to wane in the course of this year.

Needless to say, we will revisit and thoroughly discuss the longer-term risks associated with many of these issues in our annual Secular Forum in May.

Investment implications

Turning to our investment conclusions, financial markets have priced in the stronger baseline growth outlook, somewhat reduced left-tail (downside) risks and the faster path for Fed rate hikes, which we had anticipated. At current valuations we see it as appropriate to moderately scale back our credit exposures in our fixed income portfolios, while we expect to be broadly neutral on equities in our asset allocation portfolios. (For details on our asset allocation views and strategy, please visit our Asset Allocation Outlook page.)

The U.S. economy may indeed be graduating from multiple years of recovery following the global financial crisis, and there is some potential for the Fed to proceed on a more traditional tightening path (though that is not our baseline outlook). However, this is set against the combination of still muted growth in the rest of the developed world and the prospect of central banks moving closer toward the exit in Europe, the UK and Japan. One significant source of uncertainty is the prospect for U.S. dollar strengthening and the Trump administration's words and actions in response to further dollar appreciation.

Duration

While there is the potential for a rise in the level of global interest rates, it remains the case that higher yields will be limited by still high levels of public sector debt and in some cases private sector debt, as well as demographic influences and slow growth in both productivity and credit availability. The greater normalization we have seen in U.S. rates compared with Europe, the UK and Japan and historically wide spreads mean that there is the potential for global yields to reprice closer to the U.S., and this also leaves the U.S. as the most attractive source of hard duration in the event of a shock.

Given valuations and the ongoing uncertainties in the global outlook, we continue to see the current environment as one in which we should avoid big calls on macro trades and instead look to grind out alpha, take advantage of mispricings and relative value opportunities, and respond to new information. Maintaining a sufficient level of liquidity (or "dry powder") should allow us to respond as active investors to market volatility and high conviction opportunities when they present themselves.

We expect to keep portfolios fairly neutral on overall duration, with a preference for the U.S. over European, UK and Japanese duration and to maintain a bias toward curve steepening, based on the opportunity to generate income, expectations of a still measured pace for the Fed and other central bank tightening and the prospect that markets will price in greater risk premium at the longer end of global curves.

In our view, U.S. Treasury Inflation-Protected Securities (TIPS) continue to offer reasonable valuations and an attractively priced hedge against higher-than-expected inflation outcomes – particularly given the uncertainty over the extent of U.S. fiscal expansion at a time when the economy is at full employment.

Credit

We have moderately scaled back corporate credit exposures but generally expect to remain overweight in credit. We expect to continue to reduce generic investment grade and high yield positions in our portfolios, and focus instead on "bend but don't break" credits: defensive, high quality, short-dated and default remote credit exposures. Financials continue to provide some good opportunities, but we will be careful on scaling of these positions. As always, rigorous credit research is paramount.

We expect to be overweight non-agency mortgage-backed securities (MBS), which again offer defensive qualities in the event of weaker-than-expected growth outcomes in addition to attractively priced risk premia for liquidity, complexity and uncertainty over the timing of cash flows. U.S. agency MBS also offer reasonable valuations and a source of income, although we will carefully monitor

The quote

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the prospects for the Fed reducing the reinvestment of coupons and the market impact.

We remain cautious on eurozone peripheral risk, based upon the challenging secular outlook for the eurozone, political risks and the ECB's decision to scale back its quantitative easing (QE) program and the prospect for further tapering later in the year. The ECB's tapering at a time when core inflation is a long way from target in the eurozone has called into question the extent to which the ECB will support both reflation in the eurozone and peripheral sovereigns in the event of political or economic shocks. We also expect to be underweight European corporate credit at current valuations.

Currencies

While we see some potential for modest U.S. dollar strengthening versus other major currencies, this is subject to significant uncertainty over the Trump administration's response to a stronger dollar. Higher-yielding emerging market currencies offer attractive income-generating potential, but we will be careful in terms of the scaling of these positions.

Emerging markets

More generally on emerging markets, while we do not anticipate running large risk positions at current valuations, we will continue to look for good opportunities to add diversified positions to our portfolios.

Equities

We expect to be neutral on overall equity risk in our asset allocation portfolios. Equity markets have continued to rally, driven by the earnings recovery and the stronger global growth outlook. But we do not see significant upside potential for U.S. equities at current valuations in the absence of a breakthrough on corporate tax reform in the U.S. The stronger global expansion has the potential to boost cheaper cyclical markets, notably Europe, but this remains subject to eurozone political risk.

Commodities

Returns in and prospects for the commodity markets have improved materially since last year due to a combination of improved macroeconomic activity as well as material advances in the supply-side adjustment. We believe commodity allocations should be broadly at benchmark weight, as an expected increase in global GDP supports commodity demand. The correlation of commodities to other asset classes, as well as correlation within the commodity space, has returned to historical norms, pointing to the likely return of commodities as a portfolio diversifier. The positive correlation to inflation and inflation surprises also points to the benefits commodities may offer a portfolio, especially as infrastructure spending increases globally and austerity declines, as we anticipate. **FS**