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Economic Outlook

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Josh Thimons

PIMCO Cyclical Outlook for the U.S.: Will Washington's Choices Foster or Frustrate Growth?

Each quarter, PIMCO investment professionals from around the world gather in Newport Beach to discuss the firm's outlook for the global economy and financial markets. In the following interview, Josh Thimons, chairman of PIMCO's Americas Portfolio Committee, discusses PIMCO's cyclical outlook for the U.S. in 2013 – a year when policy decisions may wield heavy influence in the broader economy.

Q: Investors in the U.S. and around the world are focused on the fiscal cliff debate. What are PIMCO's views on the likely outcome?

Thimons: We believe the most likely scenario is that Congress strikes a "mini" deal before the end of the year, which will likely include a process for deficit reform to be worked out over the course of 2013. However, given the political tension in Washington we expect that negotiations could continue until the 21st of December, when Congress is scheduled to recess, or even right up until the end of the year. There is no reason for politicians to put all of their cards on the table until the very last minute.

Much of the fiscal cliff rhetoric suggests that if the fiscal cliff clock strikes midnight on January 1 with no deal, the U.S. economy would immediately fall into recession. But it doesn't really work that way. Some issues, such as the Alternative Minimum Tax patch, must be settled now. The AMT must be dealt with because it involves tax returns that will be filed starting in January and will affect millions of Americans if not extended. However, policymakers can delay many of the other decisions until next year. For instance, if there is no resolution on the Bush-era tax cuts, it will not have an immediate impact. In fact, the Treasury can buy policymakers time by instructing the IRS to not immediately update the withholding tables.

Our base case is for temporary extensions on important provisions with the difficult decisions on entitlement and tax reform deferred until 2013 or even beyond. Overall we expect to see fiscal drag of roughly 1.5% of GDP over the cyclical horizon.

Josh Thimons
Executive Vice President
Portfolio Manager

Q: Speaking of divisive issues, do you expect the debt ceiling to become a serious issue again in 2013?

Thimons: We have a comparatively benign view on the debt ceiling. First of all, we believe the most likely scenario is that a debt ceiling resolution is reached as part of the fiscal cliff compromise. Secondly, we think politicians recognize that last year's debacle wasn't good for anyone. It wasn't good for Democrats and it wasn't good for Republicans. Congressional approval ratings still have not recovered from their pre-debt ceiling levels. Therefore, we anticipate there will be less inclination to use the debt ceiling as a negotiating tactic.

Q: PIMCO believes the housing market in the U.S. finally turned around in 2012. How do you expect that to affect economic growth over the cyclical timeframe?

Thimons: Our forecast for U.S. housing is quite optimistic. Recent trends in housing data lead us to anticipate 20%–30% growth in residential investment in 2013. While this positive boost to GDP is certainly welcome, construction currently only represents 2%–3% of the national economy. Thus, even tremendous strength in housing does not translate into tremendous strength in the economy as a whole. Furthermore, enthusiasm for the housing market must be tempered due to a number of headwinds. Banking regulation is making it more difficult to securitize loans, so banks are rationing credit and looking more closely at the credit quality of buyers. It's hard to envision housing sustaining this pace of growth for more than a year or two in an environment of relatively high unemployment, muted income growth and with the economy struggling to grow at 1%–2%.

While we expect the strength in the housing sector to contribute roughly 0.5%–0.75% to growth, by itself it cannot propel the entire economy.

Q: What will be the impact of recent Fed announcements, and what else can we expect from the Fed in the coming year?

Thimons: The Federal Reserve took another large step down the path of experimental monetary policy when it announced numeric thresholds for unemployment and inflation. If the Fed's experiment works as intended, these measures could provide greater transparency into monetary policy. The hope is that business leaders and investors will be more willing to invest and to take risk if they can better predict the future behavior of the Federal Reserve in response to an evolving economy.

The paradox, however, is that while the Fed is operating almost as if it's in a laboratory, engineering complex and precise models for determining monetary policy, outside the laboratory the real economy is not responding the way the Fed would like. At some point in time, the growing marginal costs of extraordinary monetary policy accommodation may significantly outweigh the diminishing benefits of such policy. While to date the Fed has not been able to deliver the real economic outcomes it has desired, it has unquestionably provided a boost to asset markets. We worry, however, about the risks that an escalating Federal Reserve balance sheet and an apparent shift in emphasis toward employment over inflation pose to the Fed's credibility for combatting future inflation if and when it should arise.

While we certainly would not rule out future innovation from the Federal Reserve, no additional policy measures are imminent in the near term. We expect the Fed to keep the federal funds rate near zero for the entirety of 2013 and anticipate continued balance sheet expansion of around $85 billion per month to continue for much if not all of the coming year.

Q: Given PIMCO's longer-term concerns about inflation, what's our view on inflation over the cyclical horizon?

Thimons: Over the cyclical horizon, we expect U.S. inflation will continue to be benign; while the Fed's experimental policies certainly increase future risks, we do not see evidence that unwanted inflation will appear over the next six to 12 months. Headline inflation should be in the range of 1.8% to 2.3% in 2013, which is well within the Fed's newly articulated range of tolerance. While our base case currently isn't for runaway inflation, we believe over time the risk of higher inflation is greater than the risk of lower inflation. That is an important consideration for investors.

Q: What is PIMCO's forecast for overall U.S. economic growth over the next six to 12 months? And what are the major risks to that forecast?

Thimons: We expect U.S. growth in the range of 1.25% to 1.75% over the cyclical horizon, and as I said, we believe housing will be an important component. We believe there will be a positive contribution – albeit temporary – from inventory rebuilding and potentially from government stimulus and rebuilding related to Hurricane Sandy.

The main risk to economic growth is fiscal policy. The government spending and subsidies that have bolstered growth since the economic crisis began have run their course, and the fiscal authorities can no longer be counted on to contribute positively to the economy. Over time, fiscal contraction could pose considerable downside risk to economic growth.

While the developing situation in Europe has turned more favorable over the last six months, particularly from a market perspective, slower growth in Europe continues to factor into the global growth outlook. And if China and other emerging economies aren't able to sustain their high growth trajectories, this could have a spillover effect in the U.S. and other developed economies.

Q: Could you summarize the key takeaways for investment positioning in light of PIMCO's cyclical outlook?

Thimons: Some risk factors have substantially declined in 2012. The likelihood of a short-term breakup in Europe or a disruption to the global financial system appears noticeably lower now than it did at the end of 2011. Furthermore, the Fed has effectively reduced the likelihood of a deflationary spiral in the U.S. economy. However, other risk factors have intensified this year. Specifically, what was previously a longer-term issue of fiscal unsustainability in the United States has become a very near-term concern for the growth outlook – with a cliff to prove it.

Considering the impressive performance of many asset classes in 2012 – to what in many cases have become artificially high valuations – we believe investors should take a more defensive approach to risk in 2013. Federal Reserve support will continue, but its future effectiveness must be called into question. The fiscal cliff will likely be averted, but the spotlight on Washington and a likely short-term deal will mean that the unflattering debt trajectory cannot be ignored. Housing will be a bright spot in the year ahead, but on its own cannot lift the entire economy, or even fill the hole created by fiscal drag.

We believe that investors should consider reducing risk, concentrating Treasury holdings in the intermediate (five- to 10-year) part of the yield curve where direct Fed policy support will have the most impact, and rotating away from nominal assets to real assets, such as Treasury Inflation Protected Securities, commodities and real estate.

In its latest policy action, the Federal Reserve caps five years of innovation and policy action that have been instrumental in keeping economic and market conditions from deteriorating. It is now time for the politicians in Washington to pull their weight.

Table 1: PIMCO Cyclical Outlook

Forecast	Real GDP		Headline Inflation	
	Current*	Q4 '12 – Q4 '13	Current	Q4 '12 – Q4 '13
United States	2.2%	1.25% to 1.75%	2.2%	1.8% to 2.3%
Eurozone	–0.6%	–1.5% to –1.0%	2.2%	1.0% to 1.5%
United Kingdom	0.0%	0.0% to 0.5%	2.6%	2.0% to 2.5%
Japan	0.0%	0.5% to 1.0%	–0.4%	–0.5% to 0.0%
China	7.4%	6.5% to 7.5%	1.8%	2.5% to 3.0%
BRIM**	2.7%	3.5% to 4.0%	6.8%	6.0% to 6.5%
World***	2.0%	1.5% to 2.0%	2.5%	2.0% to 2.5%

*Current data for real GDP and inflation represent four quarters ending Q3 2012
**BRIM is Brazil, Russia, India, Mexico
***World is weighted average sum of PIMCO forecast countries
Source: Bloomberg, PIMCO

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