Financial Markets & Global Rebalancing: The Next Chapter

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Four Premises

1. **Finance has profoundly shaped the distribution of real economic activity** across the globe in recent years.

2. **Dislocations ushered in by the crisis will have long-term effects**, not merely cyclical ones.

3. **Neither investors nor policymakers have yet established the conceptual or institutional apparatus** needed to confront the changing relationship between emerging markets and industrialized countries.

4. **Financial markets will be a conduit & catalyst for global rebalancing**, shaping the future allocation of global production & consumption.
Finance Played an Extraordinary Role Supporting Demand Prior to Crisis (Households)...and After Crisis (US Gov’t)

Net Borrowing in the United States (% of GDP)

Massive increase in government borrowing...

...replaced the plunge in private sector borrowing.

As of June 2011
SOURCE: US Federal Reserve Flow of Funds
Certain Kinds of Demand Were Made Possible Only Through the Availability of Finance


\[ y = 0.17x - 0.00 \]

\[ R^2 = 0.40 \]

As of December 2010

SOURCE: Bureau of Economic Analysis, US Federal Reserve Flow of Funds
Long-Term Unemployment is a Potential Sign of Structural Mismatch between Aggregate Supply & Demand

U.S. Long Term Unemployment (27 weeks or more)

Elevated long-term unemployment is both symptom of mismatch & potential drag on future labor force productivity

As of September 2011
SOURCE: Bureau of Labor Statistics
Magnitude of Potential Labor Mismatch is Substantial

Beveridge Curve: Job Openings vs. Number of Unemployed Persons

3 million workers (2% of US labor force) = # of Additional Unemployed for Constant Level of Job Openings

As of September 2011
SOURCE: Job Openings and Labor Turnover Survey, PIMCO (Ivan Skobtsov)
National Deleveraging Has Barely Started in the US, Suggesting Multiyear Impact on Growth Lies Ahead

United States: Debt as % of GDP - By Sector (1952-2011)

As of June 2011
SOURCE: Bureau of Economic Analysis, US Federal Reserve Flow of Funds

At end of 2010, debt/GDP ratio was at same level as end-2007.
Europe Faces Major Structural Fiscal Adjustments

Primary Balance Adjustments Needed to Achieve Debt Targets (Using PIMCO GDP Assumptions)

- Greece: To stabilize debt ratio in 2015
- Ireland: To hit 90% debt ratio in 20yrs
- UK: To hit 60% debt ratio in 20yrs
- Spain: To stabilize debt ratio in 2015
- Portugal: To hit 90% debt ratio in 20yrs
- France: To hit 60% debt ratio in 20yrs
- Italy: To hit 90% debt ratio in 20yrs

SOURCE: PIMCO (Myles Bradshaw), European Commission. As of May 2011.
Note: The analysis reflected in this information is based upon data at time of analysis. Forecasts, estimates, and certain information contained herein are based upon proprietary research and there is no guarantee such results will be achieved.
Bond Markets Starting to Recognize Structural Nature of the Crisis

United States & Japan: 5y5y Forward vs. 5y Rate

Phase I: “Mostly Cyclical”
- Short-Term Rates Decrease
- Slowly Forward Rates Decrease

Phase II: “Mostly Secular”
- Forward Rates Decrease
- More Than Short-Term Rates

As of 27 October 2011
SOURCE: Bloomberg, PIMCO
The Global Context: Different Initial Conditions Have Produced Massive Differentiation in Economic Performance

Industrial Production Levels (Jan 2007 = 100)

Stunning differentiation between emerging and developed countries in the post-crisis period.

As of October 2011
SOURCE: Haver Analytics
Emerging Market Experience Illustrates the Centrality of Balance Sheets

Current Account Balances

Growth in 1990s heavily dependent upon external borrowing.

As of September 2011
SOURCE: Haver, IMF World Economic Outlook (WEO)
Traditional Patterns of Global Indebtedness are Being Reversed

Gross Government Debt-to-GDP Ratios

As of September 2011
SOURCE: International Monetary Fund (IMF), PIMCO
Refer to Appendix for additional outlook information.
The Committee calls for sustained actions to implement the agreed policy strategy to underpin an orderly unwinding of global imbalances. The strategy involves: steps to boost national saving in the United States, including fiscal consolidation; further progress on growth-enhancing reforms in Europe; further structural reforms, including fiscal consolidation, in Japan; reforms to boost domestic demand in emerging Asia, together with greater exchange rate flexibility in a number of surplus countries; and increased spending consistent with absorptive capacity and macroeconomic stability in oil producing countries.

-- Communique of the International Monetary and Financial Committee, September 17, 2006

Rebalancing Agenda

- Encourage consumption by transferring corporate savings to households & boosting social safety net
- Enhance domestic investment climate
- Promote small/medium & service enterprises targeting domestic demand
- Embrace financial policies & exchange rate adjustment

-- Asian Development Outlook 2009, ADB
...But Evolving Away from Dependence on the US Requires Profound Structural Changes in Global Economy

Emerging Market Growth vs. U.S. Current Account Deficit

1% point increase in US current account deficit historically correlated with 1% point increase in EM growth.

As of 30 June 2011.
SOURCE: IMF World Economic Outlook Database, PIMCO
Little Progress So Far in Rebalancing

United States: Monthly Non-Oil Trade Balance

As of June 2011
SOURCE: Haver Analytics

Traditional Framework

Industrial Countries
Interest Rate Risk

Emerging Economies
Credit Risk

New Global Fundamentals

Industrial Countries

Emerging Economies
Credit Risk
Interest Rate Risk

SOURCE: PIMCO
Rating Agencies are Behind the Curve

CDS Spreads vs. Agency Credit Ratings

Divergence between credit risk priced by market vs. by rating agencies for industrialized Europe vs. Emerging Markets.

As of 28 October 2011
SOURCE: Moody’s, S&P, Fitch, Bloomberg

*Industrial Countries*
*Emerging Markets*
Indexes are Behind the Curve

GDP- vs. Market-Capitalization – Weightings by Indebtedness

GDP weighting has more representation of low-debt countries...

GDP vs. Market-Capitalization – Weightings by Indebtedness

...and less representation of high-debt countries.

As of 30 June 2011
SOURCE: Citigroup, PIMCO
* Market Cap-weighting is represented by Citigroup World Government Bond Index (WGBI). GDP-weighting is represented by PIMCO Global Advantage Government Bond Index (GLADI Government). Refer to Appendix for additional index information.
Asset Allocations are Behind the Curve

Relative Weight of Emerging Markets

Divergence between economic and financial importance of Emerging Markets vs. allocation in investor portfolios.

As of April 2011
SOURCE: International Monetary Fund
“Push” and “Pull” Factors Favor Portfolio Rebalancing Away from Industrialized Countries into Emerging World

IMF Asset Manager Survey:
Top Five Factors Considered in Country Allocation

<table>
<thead>
<tr>
<th>Rank</th>
<th>Factors</th>
<th>Score</th>
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<tbody>
<tr>
<td>1</td>
<td>Economic growth prospects</td>
<td>190</td>
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<td>2</td>
<td>Sovereign debt issues</td>
<td>87</td>
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<tr>
<td>3</td>
<td>Inflation prospects</td>
<td>78</td>
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<tr>
<td>4</td>
<td>Interest rate differentials between countries</td>
<td>73</td>
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<tr>
<td>5</td>
<td>Industry- or sector-specific characteristics</td>
<td>62</td>
</tr>
</tbody>
</table>

As of September 2011
SOURCE: IMF Survey on Global Asset Allocation
Exchange Rate Realignments from Capital Flows Can Shape Deployment of Global Factors of Production


Electrical machinery & data processing machines are sectors where exchange rate movements could affect location of production chains.

As of August 2011
SOURCE: U.S. Census Bureau, PIMCO
Direct Investment & Expanded Access to Credit Can Catalyze Development of Labor-Intensive, Service Enterprises

Firm-Level Investment Rate, by Size and by Sector

- Small & service-oriented firms have lagged in investment vs. large & manufacturing enterprises.

SOURCE: IMF Regional Economic Outlook, October 2010
Shift in economic fundamentals drives prospective asset returns & structural changes in global investment management

Global Economic Rebalancing

Global Portfolio Rebalancing

Exchange rate appreciation & lower cost of capital encourages migration of productive resources to service of domestic demand in emerging economies

SOURCE: PIMCO
Example for illustrative purposes only.
Appendix

Past performance is not a guarantee or a reliable indicator of future results.

CHARTS
Performance results for certain charts and graphs may be limited by date ranges specified on those charts and graphs; different time periods may produce different results.

OUTLOOK AND STRATEGY
Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.

RISK
Each sector of the bond market entails risk. Municipals may realize gains and may incur a tax liability from time to time. The guarantee on Treasuries, TIPS and Government Bonds is to the timely repayment of principal and interest, shares of a portfolio that invest in them are not guaranteed. Mortgage and asset-backed securities are subject to prepayment risk and may be sensitive to changes in prevailing interest rates, when they rise the value generally declines. With corporate bonds there is no assurance that issuers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in non-Euro securities may entail risk as a result of non-Euro economic and political developments, which may be enhanced when investing in emerging markets.

INDEX DESCRIPTIONS
The Citigroup World BIG (Broad Investment-Grade) Bond ex-U.S. Index is a market capitalization weighted index that tracks the performance of international fixed rate bonds that have remaining maturities of one year or longer and that are rated BBB-/Baa3, or better, by S&P or Moody’s, respectively. This index excludes the U.S. and is unhedged USD.

The PIMCO Global Advantage Government Bond Index (GLADI Government) is a diversified global index that covers global government fixed income opportunities, from developed to emerging markets with exposure to a diversified basket of global currencies. GLADI indices use GDP-weighting approach and base allocation on national income (GDP), which embodies the capacity to replay debt. Unlike traditional indices, which are frequently comprised of bonds weighted according to their market capitalization, GLADI uses GDP-weighting which puts an emphasis on faster-growing areas of the world and thus makes the index forward-looking in nature.

It is not possible to invest directly in an unmanaged index.

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