PIMCO

Viewpoints
March 2011

World Near Tipping Point?

By Mohamed El-Erian

This interview was originally published on blogs.FT.com on 21 March 2011. In this interview, Mohamed El-Erian responds to questions from readers of beyondbrics, an FT.com blog focusing on emerging markets.

How to invest in a crisis?

beyondbrics reader: How do you see the events of recent days impacting commodities prices and land prices, especially in emerging and frontier markets that produce grains? Which sectors will benefit?

Due to the tragic events in Japan and to the Middle East uprisings, the world economy is currently undergoing both a supply and a demand shock; and it will continue to do so over the next few months.

On the supply side, national and cross-border production chains are being disrupted by the horrific events in Japan and the high and volatile price of oil, a key input for many activities. On the demand side, consumption is declining in Japan, the third largest economy in the world, while a greater share of consumers' income all over the globe is being devoted to energy and away from spending on other goods and services. And all this comes on top of a generalized, multi-month surge in commodity prices due to demand-and-supply imbalances, as well as the adverse externalities of policies in some advanced economies.

Emerging and frontier economies, as well as advanced ones, are impacted differently depending on their initial conditions and their composition of trade.

At a general level, the biggest gainers will be the oil exporters who are not currently impacted by geo-political uncertainties. These are located mainly in the set of emerging and frontier economies (e.g., Angola, Gabon, Ghana, Indonesia, Nigeria and Russia) but also in the advanced world (e.g., Norway).

The worse impacted are large net importers of commodities who also depend heavily on manufacturing exports and tourism. Many, though not all, of these reside in the advanced world and emerging Asia. Fortunately, they have higher levels of income and wealth to act as a buffer in the face of adverse external shocks. The ones in the developing world face greater challenges.

As regards sectors, it is also a story of differentiation, both across and within sectors as well as over time.

For example, the energy complex may well continue to benefit in the next few months though, within this sector, there will be increasing questions about the future of nuclear power. Meanwhile the non-tradable sector in advanced economies, most importantly real estate, will likely face renewed headwinds. Similarly for some areas of tech and, to some extent, autos, which may face production delays die to Japan's role in the vertical supply chain.

In addition to these country- and sector-specific issues, there is an important macro question that we should all keep on our radar screens: In aggregating the impact of all these exogenous shocks, how close is the world economy getting to an unfavourable tipping point?

This question assumes growing importance and complexity given that much of the potency of policy responses, be they fiscal or monetary, has been used up in the successful efforts to avoid the global depression that would have followed the 2008 global financial crisis.

Benefits for central bankers?

beyondbrics reader: Can the current new wave of uncertainty tangibly decrease inflationary expectations – by slowing down the hike in commodity prices and by triggering a move out of equities to high-grade bonds – and, if that is the case, could this make life easier for central banks in commodity-dependant emerging economies like Brazil, under a lot of strain from currency appreciation and high inflation?

A great question that involves many intricate dimensions and interactions!

The reality and uncertainties of a demand shock would, in themselves, act to reduce inflationary expectations. In monetary policy terminology, the demand destruction would cause headline inflation to converge down to a low and well-behaved core inflation level.

But, as explained in the response to an earlier question, the demand shock is being accompanied by a supply shock which has the opposite effect. Indeed, the longer the persistence of supply disruptions, the greater the risk of core inflation converging up to the more elevated headline inflation rate.

This latter phenomenon tends to be more pronounced in emerging economies where food is a larger part of the consumption basket. Moreover, the policy dilemmas you cite, including the linkage between tight monetary policy and complicating surges in capital inflows, tend to impact the effectiveness of anti-inflationary measures.

What about your questions on asset classes? Needless to say, the asset allocation effects of all the ongoing shocks are complex, to say the least, as one must also take into account developments in real economic activity and the technical positioning of markets. As an aside, this speaks to the recent pick up in both realised and implied volatility in many asset classes over the last few weeks.

When faced with these uncertainties, investors must be clear about what they think and, equally importantly, how they think it. This relates essentially to the robustness and adaptability of analytical underpinnings and the underlying frameworks.

At PIMCO, we found it advisable to complement our existing frameworks with what my colleague, Bill Gross, has labeled "safe spreads". The operational test is the identification of expected high real returns – that is, expected nominal returns adjusted for the evolution of risk factors (e.g., inflation, liquidity, volatility, credits and equity premia, etc…), as well as changing correlations across markets.

In its practical application, this concept serves to qualify in an important manner some long-standing conventional distinctions that, we believe, are less valid today – be it the one between advanced and emerging economies or the conventional notion of "safe spread" in government bonds.

Will Japan buy fewer US Treasuries?

beyondbrics reader: Will the Japanese disaster be an important factor for Treasuries? Will it result in less demand from Japan?

A great question, that speaks directly to how Japan will fund its reconstruction program.

After the required focus on human rescue operations and the stabilization of the nuclear reactors, the attention of the Japanese authorities will shift to a massive reconstruction programme to offset the impact of the terrible earthquake and devastating tsunami. The funding can come from three major sources: borrowing, debt monetisation, and the repatriation of the considerable Japanese investments held abroad.

The impact on US Treasuries will depend on the exact mix of these three. The larger the repatriation, the greater the upward pressures on US treasury yields (and, also, the implications for some other assets classes).

As regards demand, yes there will be a reduction in the Japanese component as the country's current account surplus will fall significantly. Since global balances need to add up, the reduction in Japan's surplus will be accompanied by a higher surplus/lower deficit in other countries. The net impact is what counts for US Treasuries.

Note that, according to the data issued by the US government, we have had periods in which Japan has been a net seller of Treasuries. The impact was offset by purchases by other countries, most notably China, with similar asset preferences for Treasuries.

Based on all this, and in considering the level and composition of the various marginal propensities to save that are in play, we are inclined to the view that this demand effect would be also place upward pressures on the existing level of US Treasuries yields.

QE3?

beyondbrics reader: Who is going to buy Treasuries when QE2 ends in June? Will the Fed do it again?

It is not clear to us who will step in after June 30th when QE2 formally ends; and this is a challenge both for policymakers and for current valuations in some market segments.

At current yield levels, we do not see sufficient demand coming in to offset what the Fed has been buying, be it from domestic sources or purchases from other countries. Meanwhile, on the supply side, we expect the Treasury to continue with its heavy issuance program.

At this juncture, the Fed is minimising the problem by noting that "stocks" matter more than "flows". In other words, since the Fed has effectively taken out a significant amount of Treasuries from the marketplace (and they will not be selling them), other participants have no choice but to buy the new supply. However, as others also suspect, we think that it is much more complicated than that. And recall that the FED has little history to guide its thinking here.

In response to your question on whether the fed "will…do it again," let us suppose for the sake of discussion that the economy weakens and Treasury yields spike as we get close to the June 30th expiration of QE2 and/or in its immediate aftermath.

Some will undoubtedly call either for a QE3 or for the extension of QE2. Others will warn against this type of "active inertia" in policymaking, noting that the repeated use of such an instrument will likely shift further the balance of outcomes away from "benefits" and towards what Chairman Bernanke, in his August 2010 Jackson Hole speech, correctly labeled as "costs and risks". And remember, these costs and risks – or what at PIMCO we have analysed as collateral damage and unintended consequences – have consequential economic, financial, and political elements that play out both domestically and abroad.

Taking all this into account, our inclination is that the hurdle rate for introducing a QE3 will prove to be very high, and rightly so.

An emerging market bubble?

beyondbrics reader: Investors are reallocating their fixed-income portfolios in order to increase their weightings in emerging market debt, largely government bonds and issuances by SOEs with an implicit government guarantee. Previous examples of such shifts in other asset classes have caused unsustainable bubbles. Indiscriminate buying by ill-informed new investors has often contributed to these bubbles. Given the limitations of existing analytical tools, such as credit ratings, what are the top three economic factors that investors should be focusing on to differentiate emerging market sovereigns?

The data on mutual fund flows suggest that, in the last few months, investors as a group have stopped allocating massively to emerging market bonds. In fact, there have been a few weeks of net redemption after very, very large inflows in 2010. This phenomenon is even more acute for emerging market equities.

These flow patterns tend to be large relative to the absorption ability of markets. As such, emerging markets tend to be subjected to both over-shoots and under-shoots that are not warranted fully by changes in underlying fundamentals. While these movements have tended to decline with the gradual maturation of the asset class, they must always be considered in investors' decisions regarding the scaling and timing of their allocations.

We would agree with you that it is unwise to rely just on the ratings issued by credit rating agencies. Indeed, at PIMCO, our analytical work eschews these ratings preferring, instead, to focus on our internal assessments. This process of continuous re-evaluation is, of course, part of a broader investment philosophy and process.

As to the specific factors, the key is to cover those that materially influence sovereigns' ability and willingness to pay; and do so pro-actively. We thus focus on solvency and liquidity variables for debt and debt service, economic growth potential, and policy responsiveness. This allows the continuous comparison of our forward-looking assessments of credit with what is being priced by various segments of the markets.

A sales tax to pay for US pensions?

If the old saying is true and demography is destiny, the developed world faces a tsunami of pensioners over the next thirty years. How can our economy cope with these retirees drawing down on health care and other services, and who will pay for it? Do you see a national sales tax in the future to pay for this?

These are critical issues that are finally attracting more attention in policy circles. It is critical that the resulting deliberations lead to meaningful and timely actions to pre-empt big problems down the road.

Should such actions not be forthcoming, we suspect that the answer to your questions will be yes, yes, and yes.

Yes, demographic factors are important and, indeed for some countries, will become crucial in the years ahead and will overwhelm more conventional economic and financial factors. This is particularly true for rapidly aging societies that have made large entitlement promises (pensions, health care, etc.) that they will find difficult to deliver on.

Yes, there is a question as to who will pay and through which mechanisms. Depending on the country, we will see a mix of higher inflation, increased taxation, and disappointments on long-standing entitlement promises.

And yes, we think that a national sales tax in the US will likely be an option that will attract lots of deliberations and, potentially, application.

Printing money not enough for Ireland

To me it seems that the Irish government needs to print money, by one means or another, to fill the gap left by the toxic bank assets in Ireland. Do you agree? How could the Irish central bank do this in an imaginative way, considering the coupling to the European central bank and the complexities of European politics which determine how the Euro is managed?

Let us start with the sad facts.

Ireland's public finances have been overwhelmed, and in a bad way, by the decision to assume so many banking sector liabilities. Because of that, the country faces a series of potential challenges.

The huge budget hole requires a massive fiscal adjustment notwithstanding large bail out funding from the ECB, EU and IMF. The related uncertainties add to the headwinds facing growth and employment creation. And membership of the Euro-zone limits policy options.

I suspect that these factors are the ones leading you to explore an "imaginative way" for Ireland to "fill the gap left by the toxic bank assets" – and correctly so.

Believe it or not, Ireland is already doing what you suggest. It works in the following way:

Public debt instruments are issued to the banking system which then turns around and exchanges them for cash with the ECB, either directly or via the Irish central bank. In effect, money is being printed.

We think that this will not be enough for at least two reasons.

First, there is an issue of size. Ireland's toxic asset problem is large, and will get larger if the economy is not able to quickly restore economic growth.

Second, the type of funding that is being used is too partial. It provides liquidity but not solvency support. As such, the protracted debt overhang acts to discourage new investments that are key to Ireland's ability to grow at a high and sustained level.

Viewpoints
March 2011

Singapore[1]
PIMCO Asia Pte Ltd
501 Orchard Road #08-03
Wheelock Place
Singapore 238880
65-6491-8000
Registration No. 199804652K

Hong Kong[2]
PIMCO Asia Limited
24th Floor
Units 2403 & 2405
Nine Queen's Road Central
Hong Kong
852-3650-7700

[1] Regulated by the Monetary Authority of Singapore as a holder of a capital markets services license for fund management, and an exempt financial adviser. The services and products provided by PIMCO Asia Pte Ltd are available only to accredited investors, expert investors and institutional investors as defined in the Securities and Futures Act. The investment management services and products are not available to persons where provision of such services and products is unauthorised.

[2] Licensed by the Securities and Futures Commission for Types 1, 4 and 9 regulated activities under the Securities and Futures Ordinance ("SFO"). The services and products provided by PIMCO Asia Limited are available only to professional investors as defined in the SFO. The asset management services and investment products are not available to persons where provision of such services and products is unauthorised.

"Safe Spread" is defined as sectors that we believe are most likely to withstand the vicissitudes of a wide range of possible economic scenarios. All investments contain risk and may lose value.

Commodities contain heightened risk including market, political, regulatory, and natural conditions, and may not be suitable for all investors. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Sovereign securities are generally backed by the issuing government, obligations of U.S. Government agencies and authorities are supported by varying degrees but are generally not backed by the full faith of the U.S. Government; portfolios that invest in such securities are not guaranteed and will fluctuate in value.
This material contains the opinions of the author but not necessarily those of PIMCO and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. This material was reprinted with permission of the Financial Times. Date of original publication 21 March 2011.