

PIMCO Cyclical Outlook: Policy Dissonance and Geopolitical Risk Beget Economic Decoupling

The U.S. economic policy mix in the post-crisis era has been far from perfect. But, when compared and contrasted with policies enacted in other countries over the same period, the relative lack of policy dissonance in the U.S. clearly stands out, giving birth to our forecast of superior cyclical U.S. economic performance versus the rest of the world.



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This post-crisis economic policy mix has focused on achieving a handful of crucial outcomes:

- 1) Force the financial sector and bond markets to take credit losses from the crisis early and quickly.
- 2) Stress test financial sector balance sheets, and turbo-charge conservative recapitalization plans with public money.
- 3) Provide publicly funded aggregate demand while privately funded aggregate demand is contracting.
- 4) Use central bank balance sheet policy first to normalize systemically important financial risk premia, and thereafter to stabilize medium- to long-term inflation expectations close to the 2% objective regardless of realized cyclical undershooting.
- 5) Set and leave short-term nominal “risk-free” interest rates well below the level of expected inflation in the medium to long term for an extended period to facilitate financial asset reflation, ultimately leading to a faster recovery in private sector balance sheet health.
- 6) Monitor financial market prices for destabilizing overshoots, and act as appropriate to prevent them.

Thus far, the U.S. business cycle has progressed largely as expected (although with a lower amplitude and longer frequency than many predicted post-crisis):

- 1) Expansionary fiscal policy provided a significant cushion to declining aggregate demand in 2009.
- 2) Private sector de-stocking in 2009 turned to private sector re-stocking in 2010 on the back of publicly funded aggregate demand growth.
- 3) Private sector final demand began to expand in 2011, led by short average life consumer durables consumption, which tends to be most responsive to easing financial conditions.
- 4) Long average life housing investment joined the private sector final demand recovery in 2012, as the financial sector became fully recapitalized and U.S. real estate prices became cheap from a valuation perspective.
- 5) Services consumption and aggregate labor market demand accelerated in 2013.
- 6) Capacity utilization increased in 2014 due to a lack of capital expenditures, giving rise to better generalized pricing power for corporations.

Looking forward, these are the likely natural next steps in the U.S. business cycle:

- 7) Improved pricing power, less slack in labor markets and productive capacity, combined with still easy financial conditions in 2014, lead to an increase in expected ex ante returns on newly invested capital, sparking a capital expenditures acceleration in 2015.
- 8) Accelerating capital expenditures in 2015 reinvigorate the flagging operating profits' recovery in 2016, thereby creating the necessary conditions for a self-sustaining private sector positive feedback loop and an eventual exit for the Federal Reserve from extraordinary monetary policy.

Our economic forecast for the next 12 months calls for a continuation of this low amplitude, long frequency U.S. business cycle recovery. With the ongoing assistance of

easy monetary policy combined with healthy private financial sector balance sheets, the U.S. economy is poised to grow between 2.5% and 3.0% in the coming year with corporate capital expenditures accelerating on the back of rising pricing power and ex ante expected returns on newly invested capital. Key risks to this forecast are concentrated in the external sector (the rest of the world's impact on U.S. exports is discussed below) and in the domestic measurement of economic slack, wherein expectations for a very gradually rising rate of wage and product prices allow for easy financial conditions to remain in place for another 12 months or so. (For a discussion of our secular outlook, see "The New Neutral" by Bill Gross and Richard Clarida, May 2014.)

While the U.S. cyclical outlook is becoming more sure-footed and self-sustaining, the cyclical growth and inflation outlooks for the eurozone and Japan remain hostage to significant policy dissonance and geopolitical risk there.

In the eurozone, expansionary fiscal policy in the form of aggregate demand support and/or financial sector balance sheet repair has been absent in the post-crisis period (with a few exceptions) and is unlikely to play a role in cyclical developments next year. Yes, fiscal drag will decline on a sequential basis, but the impact on eurozone growth from fiscal policy inaction will be negligible. As such, large output and employment gaps amid liquidity trap conditions will be treated solely by the medication of monetary policy via the European Central Bank (ECB), which is slowly starting to act in a more concerted manner.

We expect the ECB to continue to ease monetary policy in the eurozone over the cyclical horizon via some form of quantitative easing during 2015, which will involve the large-scale purchase of sovereign bonds, mostly because we do not find either the TLTRO (targeted longer-term refinancing operations) program or the ABS (asset-backed securities) purchase program already announced to be sufficient in arresting the liquidity trap conditions responsible for declining inflation expectations there. The eurozone economy should grow by about 1% in the next

12 months, continuing a painfully slow climb out of a double-dip recession. A stronger U.S. economy will assist the eurozone recovery next year, via better exports and also via a stronger U.S. currency versus the euro.

In Japan, policy dissonance is not quite as pronounced as in the eurozone, but the initial conditions of demographic decline and debt deflation are somewhat worse. While we were very encouraged by Japan's announcements of expansionary fiscal and monetary policies during 2012, the premature reversals of expansionary fiscal policy in 2014 and 2015 (expected) are creating significant uncertainty and volatility in the economic outlook there. Once again, the burden of ongoing policy medication in Japan will fall squarely on the Bank of Japan (BOJ) in 2015.

We expect the BOJ to continue its current rapid pace of balance sheet expansion for the balance of 2014, with some possibility of faster expansion in 2015 depending on the global economic environment. A healthier U.S. economic outlook, leading to a strong U.S. currency versus the Japanese yen, will help the BOJ maintain growth and inflation expectations close to target despite more fiscal tightening to come. This is our current base case, and we expect Japan will grow by around 1% to 1.5% in the next 12 months as a result.

Turning to China, and to emerging markets more broadly, we see policy dissonance of a different class altogether. The developing countries do not face the same cyclical pathologies (borrowing from Paul McCulley) as the developed countries. For most major developing countries, the key cyclical growth challenges involve a developmental transition from easy "low income mercantilist" growth models to more nuanced and diversified "middle income" growth models that involve broadening the economic base via continued investment in higher-value-added production and the introduction of financial and other service sector segments to the private economy.

China, Brazil, India and Mexico are all struggling currently to achieve the right policy mix to overcome these hurdles. Part of the problem is that the external demand environment for developing economies continues to be weak (because of either a more competitive U.S. economy

or a weaker eurozone economy), but a more important part of the problem is that developing countries have wasted the post-crisis period by focusing too much on cyclical policy changes as opposed to structural ones.

China's policy mix in the post-crisis period has relied more on the tremendous amount of public sector balance sheet flexibility available to policymakers and less on liberalization and development policies necessary to sustain growth for a longer frequency.

The current Chinese growth model of public sector directed investment and financial repression leading to a real estate boom is slowly but surely running out of steam. While we recognize the high fiscal flexibility available for aggregate demand management in China, we also see continued signs of an over-leveraged financial and non-financial corporate sector there leading to slower and less stable growth going forward. We remain more pessimistic on the Chinese cyclical outlook than consensus expectations and look for growth to slow to around 6.5% during 2015. Further, our degree of certainty on Chinese economic growth is lower than in other countries for the cyclical horizon ahead.

The outcomes for other developing economies will be tied to what happens in China next year. While Mexico and India are less tied to China, and recently both show signs of accelerating structural policy changes necessary for growth, Brazil and Russia will continue to look to China for external demand support. We expect that as a group, the BRIM economies will grow just 2% in 2015, a significant slowdown from the 3% to 5% growth rates achieved in prior years.

Russia in particular will face significant challenges in 2015, exacerbated by economic sanctions being placed on its banks and corporations due to the ongoing conflict in Ukraine. We expect the Russian economy to outright contract during 2015, and we do not rule out a further escalation in economic sanctions and trade barriers being imposed there. While Iran-style sanctions are unlikely over the cyclical horizon, developments in Ukraine will dictate the outlook for Russia going forward.

Finally, a word on geopolitical risks facing the global economy. The hot zones of Ukraine, Syria and Iraq are well-known by now, with Ukraine posing the most significant threat to the eurozone outlook via potentially intensifying tit-for-tat sanctions with Russia. While we see a very low probability of Iran-style sanctions being imposed on Russia, the outcome of such sanctions would easily throw the eurozone back into a recession (triple-dip). While the crisis in the Middle East is not expected to have

much impact on the global economy in the next 12 months, we cannot ignore the rising tensions between China and Japan when we think about impactful geopolitical risks. The timing of rising tensions between China and Japan is unpredictable, but if a recent poll conducted by a major financial newspaper is anything to go by, this is the biggest geopolitical risk to the global economy ahead.

TABLE 1: CYCLICAL OUTLOOK

Forecast	Real GDP		Headline Inflation	
	Current*	Q3 '14 – Q3 '15	Current*	Q3 '14 – Q3 '15
United States	2.5%	2.5% to 3.0%	1.9%	1.75% to 2.25%
Eurozone	0.7%	0.75% to 1.25%	0.3%	0.75% to 1.25%
United Kingdom	3.2%	2.5% to 3.0%	1.6%	1.75% to 2.25%
Japan	-0.1%	1.0% to 1.5%	1.3%	0.75% to 1.25%
China	7.5%	6.0% to 7.0%	2.2%	2.5% to 3.5%
BRIM**	1.6%	1.5% to 2.5%	6.7%	5.5% to 6.5%
World***	2.6%	2.25% to 2.75%	2.2%	2.25% to 2.75%

* Current data for real GDP and inflation represent four quarters ending Q2 2014

** BRIM is Brazil, Russia, India, Mexico

*** World is weighted average sum of countries listed in table above

Source: Bloomberg, PIMCO calculations

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