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## In a Challenging Environment, Policy Easing Sweeps Through Asia

In the following interview, Adam Bowe, executive vice president and fixed income portfolio manager in the Sydney office, Tomoya Masanao, managing director and head of portfolio management Japan, and Isaac Meng, senior vice president and emerging markets portfolio manager in Hong Kong, discuss the conclusions from PIMCO's quarterly Cyclical Forum in March 2015 and how they influence our Asian outlook and investment strategy.



**Q:** A few months ago, PIMCO was expecting a challenging year ahead for Asia's economies. Have there been any changes to the cyclical outlook for the region or surprises in the first quarter?

**Adam Bowe:** The real surprise of the first quarter of 2015 was the breadth and degree of monetary policy easings globally, and in particular within the Asian region. The central banks of India, Singapore, Australia, China and Indonesia all provided policy accommodation to start the year. This was in part a response to further easings globally, which risked putting unwanted upward pressure on regional exchange rates, in addition to sluggish domestic growth and inflation outcomes. While we expect this to be marginally net positive for regional growth and inflation, the effects are only likely to be felt toward the end of our cyclical horizon.

So we still expect the macro environment to remain challenging in Asia over our cyclical horizon, and indeed the first quarter of 2015 has been broadly consistent with this outlook. The key forecast change to the region has been our modest further downgrade to our already below-consensus growth forecast for China: We now expect growth in the low 6% territory compared with mid-6% a few months ago. Despite additional easings from the People's Bank of China (PBOC), lower inflation outcomes have resulted in little change to real borrowing rates, which remain elevated on a historical basis. As China continues to address the ongoing slowdown in its property sector and deleveraging in the shadow-banking system, we expect lower real borrowing rates will be required to successfully achieve a soft landing.

Our outlook for Japan has not changed materially, and we continue to expect growth to recover from last year's technical recession, following the expansionary policy decisions late last year to delay the next value-added tax (VAT) hike and increase the size of the Bank of Japan's (BOJ) easing program. Japan will also benefit from the further decline in oil prices since last quarter and past depreciation of the yen. And in Australia, we continue to forecast below-consensus growth as the economic transition away from the mining sector continues to be a very gradual process.

**Q:** Japan's GDP did not grow in 2014. Looking ahead, PIMCO forecasts 1.5% growth. Will this strong growth be sustainable?

**Tomoya Masanao:** Over the cyclical horizon, we remain constructive on Japan's growth, forecasting around 1.5% or well above its potential, though sustainability of high growth is questionable beyond this horizon.

A bright spot in Japan is the corporate sector. Corporates, particularly large exporters, are benefiting from the tailwinds of domestic policies and external developments. Exporters' profits should rise with the U.S. growth recovery and the depreciation in the yen to date. Domestic-focused corporates will also be likely beneficiaries of lower oil prices, which mitigate the adverse effect of the currency devaluation on input prices. Planned corporate tax cuts, corporate governance codes, other pro-business policy initiatives and, importantly, political stability are having important positive effects on corporate behavior.

The cyclical outlook for consumers is also constructive. Nominal wages, particularly for workers at large companies, should grow, which together with the base effect of headline inflation will help real wage growth turn positive. Consumption growth will likely also naturally be strongly above its trend as it is starting from a low base after the VAT hike. However, the sustainability of consumption growth is questionable. A hysteresis effect from past wage deflation should continue to weigh on workers' future expectations for wages. Retirees will obviously not benefit from any positive wage development and only feel pain from headline inflation as it rebounds from here.

**Q:** Japan's inflation rate has collapsed recently. What is your inflation outlook? How will it shape your investment strategy?

**Masanao:** Despite above-trend cyclical growth, we believe that inflation will remain subdued. Though the core Consumer Price Index (CPI) could rebound towards 1% by next spring, partly due to a lag effect of the currency depreciation, it will likely still be well below the policy target of 2%. The output gap remains, and inflation expectations are not yet re-anchored to the policy target level. Our benign inflation outlook suggests that the BOJ

will at least continue the current aggressive monetary policy and possibly ease further, which should remain one of the key drivers of our global investment strategy.

### **Q:** How effective do you think the recent PBOC rate and reserve requirement cuts will be in stabilizing growth and inflation in China?

**Isaac Meng:** The limited easing so far is insufficient to offset the strong headwinds to growth, and we expect GDP growth will further slow to the 5.75%–6.75% range, and the CPI will stay down around 2%, below the official target of 3%. Despite the strong headwinds of property adjustment, local fiscal reform and shadow-banking deleveraging, policymakers are not ready to aggressively stimulate the economy for fear of compounding the debt risks; this is known as “China’s New Normal” adjustment.

So far, the measured monetary easings are reactive in nature and designed to cushion the downside, and thus, are largely behind the curve in loosening tight monetary conditions. Since November, the PBOC has cut the benchmark deposit rate twice by 50 basis points and cut the reserve requirement by 50 bps; adjusted for sharply falling inflation, however, real rates have actually increased. There are also the complications that both fiscal reform and the liberalization of deposit rates on the margin will tighten the policy stance.

### **Q:** Given your view that recent policy moves will not provide the necessary support, what is the likelihood that the PBOC will join the global currency war by sharply devaluing the yuan?

**Meng:** Very unlikely. Fundamentally, the yuan is not overvalued. Chinese exports are gaining marketshare, and the commodities price collapse is boosting the balance of payments by US\$150 billion. To counter growth/deflation risks, there is plenty of room for the PBOC to cut rates domestically. As the world’s biggest exporter, China’s trade surplus and bilateral trade balance with the U.S. both hit record highs in 2014. If the PBOC pursues a devaluation policy explicitly, there is the risk of triggering a competitive devaluation. Politically, a competitive devaluation policy is counter to the strategic objective of elevating the yuan and China’s role in the global monetary system.

### **Q:** The Reserve Bank of Australia (RBA) re-engaged the easing cycle in February with a rate cut of 25 bps. What is driving policy and what are PIMCO’s expectations going forward?

**Bowe:** Australia’s outlook continues to be dominated by the fragile domestic rebalance away from mining-led growth in the context of slowing growth in China. This is resulting in sub-trend growth in domestic demand and weak national income growth due to the declining terms of trade from lower bulk commodity prices. Historically, Australia’s floating exchange rate would play a more prominent role in facilitating this economic rebalance, but the aggressive monetary policy actions of many other central banks (particularly the BOJ and ECB) are restricting the degree to which the exchange rate is declining on a trade-weighted basis. We expect these macro themes to persist and forecast below-consensus real GDP growth and inflation over the cyclical horizon. This combination of subdued domestic demand, weaker national income growth and a still-elevated trade-weighted exchange rate will likely require the RBA to lower interest rates again over the coming months and keep policy accommodative for an extended period.

### **Q:** What are the investment implications of PIMCO’s cyclical outlook for Asia?

**Bowe:** In terms of interest rate exposure, we retain our yield-curve flattening bias in Japan, as the net supply for long-maturity Japan Government Bonds (JGBs) is now negative after the BOJ increased the scale of its purchases late last year. We expect the volatility of this position to be higher going forward and dependent on the timing of Ministry of Finance issuance and BOJ purchases, but expect the flattening trend to persist as outstanding JGBs continue to be absorbed throughout 2015.

Despite our cautious macro view in Australia, we think interest rates look fairly priced, with the market expecting the RBA to ease the policy rate twice more to 1.75% over the cyclical horizon. Given the recent outperformance of Australian duration and the lower levels of carry due to the flat yield curve, we think duration overweighting relative to U.S. Treasuries is less compelling at current levels.

Our highest conviction views are in the currency markets, and we remain short the yen and the Australian dollar against a long U.S. dollar position. We expect the BOJ to continue to aggressively expand its balance sheet, with the risk that it increases this stimulus toward the end of the cyclical horizon. In addition to the impact of public and private balance sheets in Japan rebalancing away from JGBs into foreign equities and bonds, this should continue to weaken the yen relative to the U.S. dollar. A re-engaged RBA, weaker bulk commodity prices and our below-consensus forecast for China also support short positions in the Australian dollar. Given our view that the PBOC will not significantly devalue the exchange rate, we are also biased to be overweight the yuan.

FORECAST	REAL GDP		HEADLINE INFLATION	
	CURRENT*	Q1'15 – Q1'16	CURRENT*	Q1'15 – Q1'16
UNITED STATES	+2.4%	+2.5% to +3.0%	+1.6%	+1.5% to +2.0%
EUROZONE	+0.9%	+1.25% to +1.75%	+0.2%	+0.75% to +1.25%
UNITED KINGDOM	+2.7%	+2.5% to +3.0%	+1.6%	+1.0% to +2.0%
JAPAN	-0.5%	+1.25% to +1.75%	+0.5%	+0.75% to +1.25%
CHINA	+7.3%	+5.75% to +6.75%	+1.5%	+1.5% to +2.5%
AUSTRALIA**	+2.5%	+2.5% to +3.0%	+1.7%	+2.0% to +2.5%
BRIM***	+1.9%	+1.5% to +2.5%	+7.0%	+6.0% to +7.5%
WORLD****	+2.5%	+2.5% to +3.0%	+1.7%	+1.75% to +2.25%

\*Current data for real GDP and inflation represent four quarters ending Q4 2014 or Q3 2014 if data not yet released

\*\*Australia forecast is from PIMCO's portfolio management team in Sydney

\*\*\*BRIM is Brazil, Russia, India, Mexico

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

Source: Bloomberg, PIMCO calculations.

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