It?s hard for one of the biggest bond managers in the world to forecast a recession when financial conditions are as favorable as they are now. Still, PIMCO isn?t sure if the global economy is being propelled by the ?sugar rush? of easy financial conditions. The firm?s global Economic Advisor and Chief Investment Officer of Global Fixed Income, Joachim Fels and Andrew Balls, respectively, write in a new paper that their base case hypothesis remains that the global economic expansion is demand-driven, but they have ?considerable uncertainty around this key question.? Fels and Balls report that the bond behemoth in Newport Beach, Calif. now forecasts modestly higher 2018 GDP growth than it did at the end of 2017 in the U.S., eurozone, the U.K., and China. However, it has lowered its expectations for Mexico and India. Overall, the global forecast for growth remains in the 3.0%-3.5% range. PIMCO concedes that their forecasts are baked into asset prices. In other words any disappointment on growth or inflation estimates would spell bad news for portfolios, so the firm remains conservatively positioned. PIMCO views the U.S. Government's infrastructure plan as having a ?low probability? of passing through Congress anytime soon. The firm?s municipal bond team offered that contribution from the states to such a plan would be limited given ?lack of fiscal space in many state coffers.? On trade policy, PIMCO expects the tariff proposals on steel and aluminum to be ?watered down further? beyond the exemptions already given to Canada and Mexico. Retaliation by Europe and others should also be limited. Neither would broader protectionist action against China regarding intellectual property spark an aggressive response. On emerging markets, the firm remains mildly optimistic, but is aware of growth slowing due to deteriorating demographics, political risks, and protectionist sentiment.

New Neutral Intact?

Immediately following the financial crisis, PIMCO propounded a ?New Normal? or ?New Neutral? thesis arguing (correctly) that subsequent growth would be tepid and interest rates would be low. The firm relied on an influential book from economists Ken Rogoff and Carmen Reinhart called *This Time It?s Different*, a historical examination of debt crises that claimed past crises tended to slow future growth until the debt was worked off. Currently, the firm thinks the thesis is intact because of all the debt that?s still accumulated and the need for economies to keep rates low in order to maintain growth. But PIMCO is slightly less certain about its view that rates must remain as low as they?ve been. Demographics influencing the new normal have not changed, however, and the firm doesn?t think tax cuts in the U.S will spur meaningful long-term growth. Fels and Balls write that while there is some risk to rising yields, ?we do not think that we are at the start of a secular bear market for bonds.? The authors add that there is a good chance that there will be a recession over the next 3-5 years, and that there will be ?limited capacity for conventional monetary policy, compared with historical experience? at that time.

Investment Implications And Portfolio Positioning

As a consequence of this analysis, PIMCO is avoiding big macroeconomic bets currently. The firm maintains ?modest duration underweights,? including in Japan. The firm is also mildly overweight in TIPS. PIMCO tends to avoid generic corporate bonds, and gets its corporate exposure from short-dated structured products. The firm also likes some non-agency mortgages currently. The firm prefers to get exposure to emerging markets through currencies rather through bonds at the moment. Currencies are ?the best way to express a positive view on EM fundamentals and to generate income.? PIMCO is neutral on U.S. stocks, but likes Japan, as it anticipates earnings growth there. Finally, the firm is modestly overweight in commodities ? especially energy and base metals -- ?due to their stand-alone return prospects and their potential diversification benefits should the global economy accelerate, elevating realized inflation.?

Outlook for Major Economies

For the U.S., PIMCO expects above-trend real GDP growth in the 2.25% to 2.75% range in 2018. Low unemployment should continue, putting some pressure on wage growth and consumer price inflation. The Fed will gradually push rates higher under new leadership, making progress toward the 2% objective. Growth momentum is strong and financial conditions are favorable in the eurozone. GDP growth should be between 2.25% and 2.75% for the year. The eurozone recovery is now broader than it has been in the past. Inflation and wage pressure are down, however, because of remaining labor slack and ?persistent competitiveness gaps among member states.? PIMCO doesn?t anticipate a rate hike from the ECB until mid-2019. In the U.K., PIMCO expects 1.5%-2% real GDP growth in 2018. Growth should pick up with progress toward separation from the EU. The Bank of England should hike rates twice unless Brexit talks break down. PIMCO?s base case for Japan is a continuation of growth in a 1%-1.5% range. With an unemployment rate below 3%, wage growth should pick up, helping core inflation to rise to slightly below 1%. Finally, PIMCO expects a ?controlled deceleration? of China?s GDP growth toward around 6%-7%. Inflation should accelerate on a core basis and from higher oil prices. This should encourage the People?s Bank of China to hike rates. PIMCO is neutral on China?s currency, and expects China to control capital flows to damp exchange rate volatility.