

Inflation Outlook 2012: Benign, But Watch the Tails

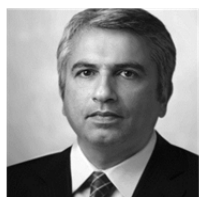
Looking ahead into 2012, PIMCO expects modest inflation to continue, as last year's pricing pressures have eased. But there are risks to that scenario, both to the upside and downside.

Headline inflation, as measured by the Consumer Price Index (CPI) in the U.S., ran at 3.0% in 2011, up from 1.5% for 2010. The Core CPI, which excludes the volatile food and energy components, also accelerated from a 0.8% increase in 2010 to a 2.2% increase in 2011. As we look at the underlying components, we do not expect this trend of rising inflation rates to continue this year. Our base case is for inflation to moderate and trend lower from current 3% levels. However, there are a number of factors that could tip us either way – much higher inflation or even temporary deflation. Longer term our bias is toward higher inflation, and we feel any deflationary episode is likely to be short-lived, as the one we saw in 2008.

2011 Review

Inflation in 2011, relative to 2010, was about one major trend and several one-off factors. The major trend we refer to was a stabilization and subsequent increase in the pace of shelter, or rent, inflation. Inflation in the cost of shelter increased from 0.5% in 2010 to 1.9% in 2011. The driving force behind this increase in the pace of inflation was a combination of the stabilization in housing prices as well as a shift in sentiment from buying a home to renting.

Predicting trends and turning points in shelter inflation, like that which occurred in 2011, is important because not only is the cost of shelter the largest component of the U.S. consumption basket, but also a particularly slow moving series and trends change only very slowly. The chart below shows the historic trends in shelter inflation along with our PIMCO model – importantly the model shows that the recent acceleration in inflation is unlikely to continue into 2012. Instead, shelter inflation will likely be stable at around 2%. Anecdotal evidence from industry surveys and brokers already points to some softening in the asking price of rents nationally.



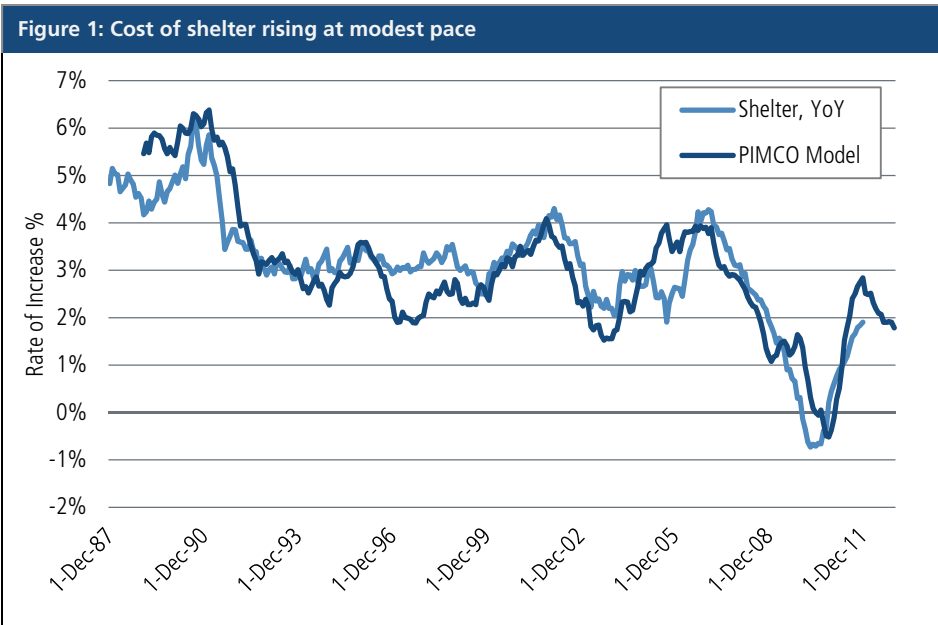
Mihir P. Worah

Managing Director
Portfolio Manager



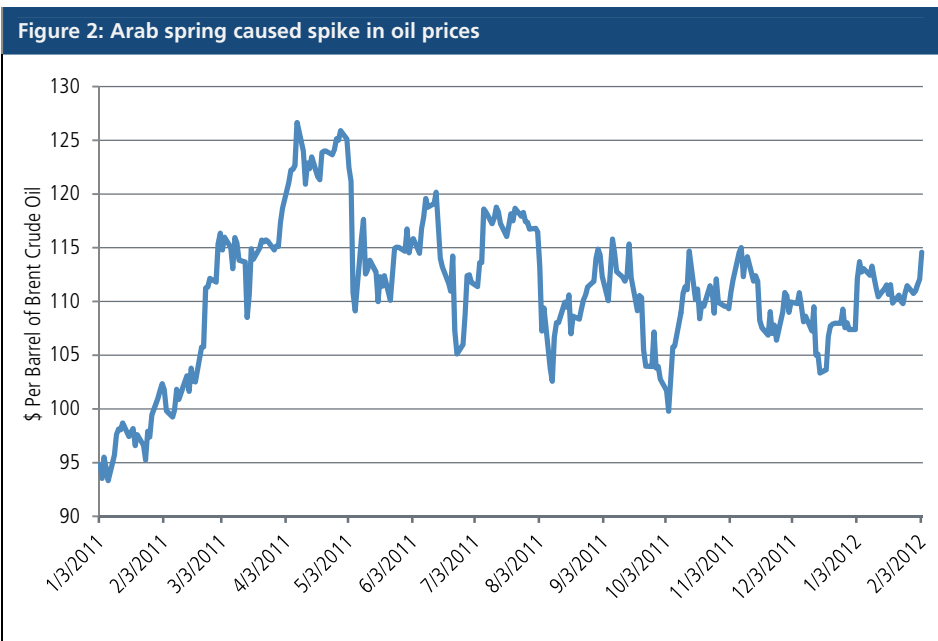
Nicholas J. Johnson

Executive Vice President
Portfolio Manager



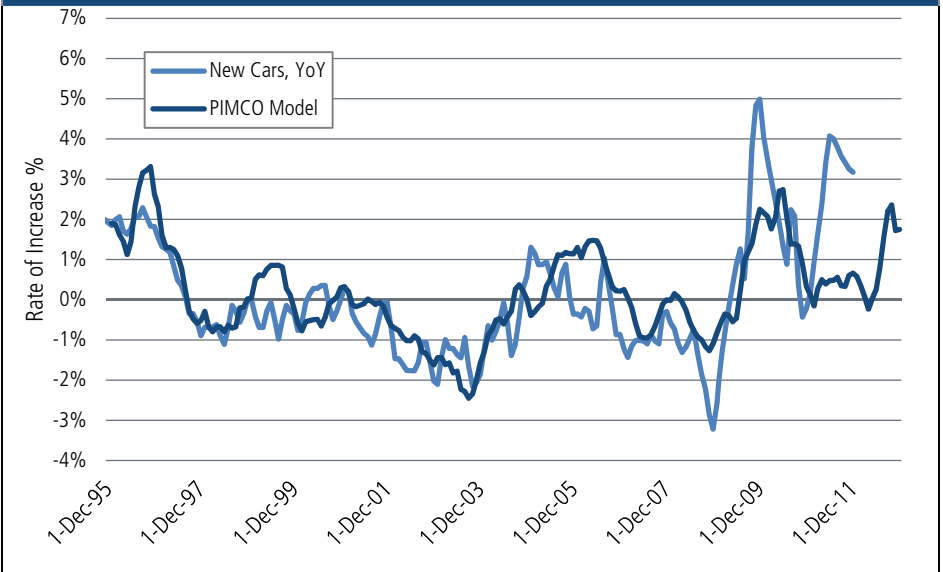
Source: U.S. Bureau of Labor Statistics (BLS), PIMCO. Data as of 31 January 2012. PIMCO Model is company forecast to end of 2012. Shelter costs based on BLS survey of rent paid by consumers, or owner equivalent cost.

In addition to this acceleration in shelter costs, there were four distinct one-off factors that combined in 2011 to produce higher inflation. They were a spike in oil prices in early 2011 due to Arab spring (Figure 2), increased car prices related to the Tsunami in Japan (Figure 3), higher food prices resulting from a rise in grain prices after poor U.S. corn yields (Figure 4), and finally, higher apparel prices resulting from a spike in cotton prices due to floods in Pakistan.



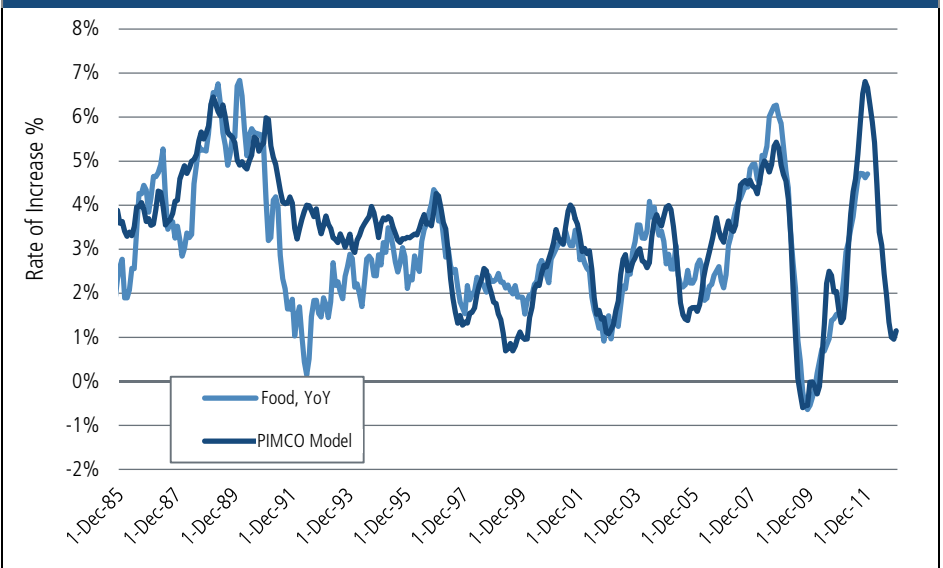
Source: Bloomberg. Data as of 3 February 2012

Figure 3: Cost of new cars increased after Tsunami in Japan



Source: U.S. Bureau of Labor Statistics, PIMCO. Data as of 31 January 2012. PIMCO Model is company forecast to end of 2012. Changes in prices paid for new vehicles based on BLS survey.

Figure 4: Food prices rose last year on poor corn yields



Source: U.S. Bureau of Labor Statistics, PIMCO. Data as of 31 January 2012. PIMCO Model is company forecast to end of 2012. Cost changes based on BLS survey of prices paid for certain common foods.

2012 Outlook

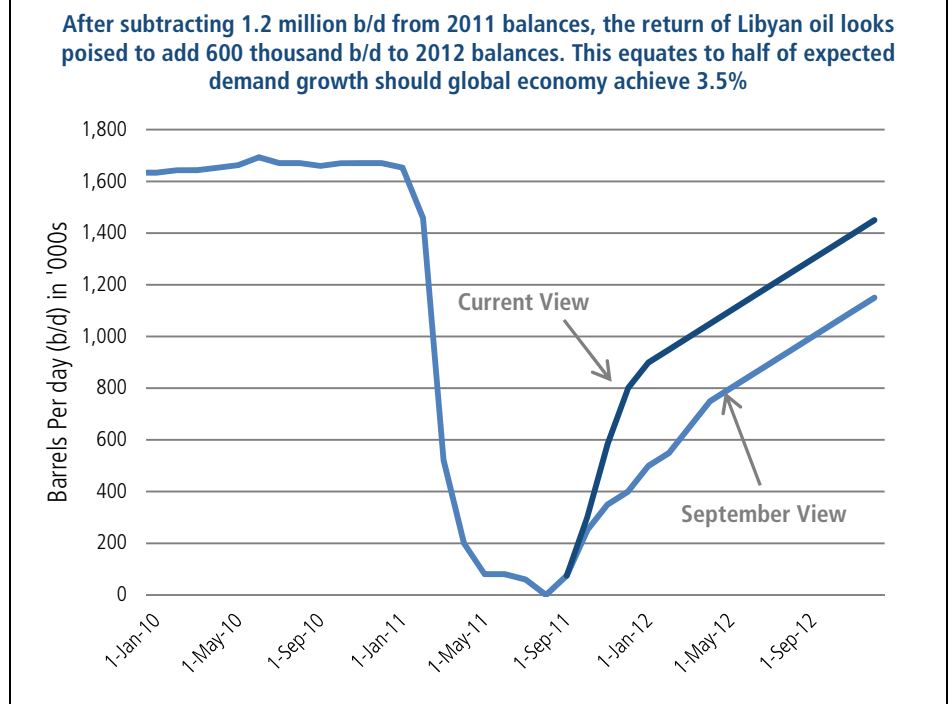
Absent a severe disruption in crude oil supplies from an Iran type event or a disorderly default or breakup within the eurozone, we see inflation moderating and heading to slightly below 2% on a year-over-year basis. This is a result of shelter inflation stabilizing at current levels as well as the one-off inflationary pressures from new cars, food, and apparel ultimately proving transient.

The models in Figures 1, 3 and 4 show that future rises in the price of shelter, cars and food can often be anticipated by evaluating conditions prevalent

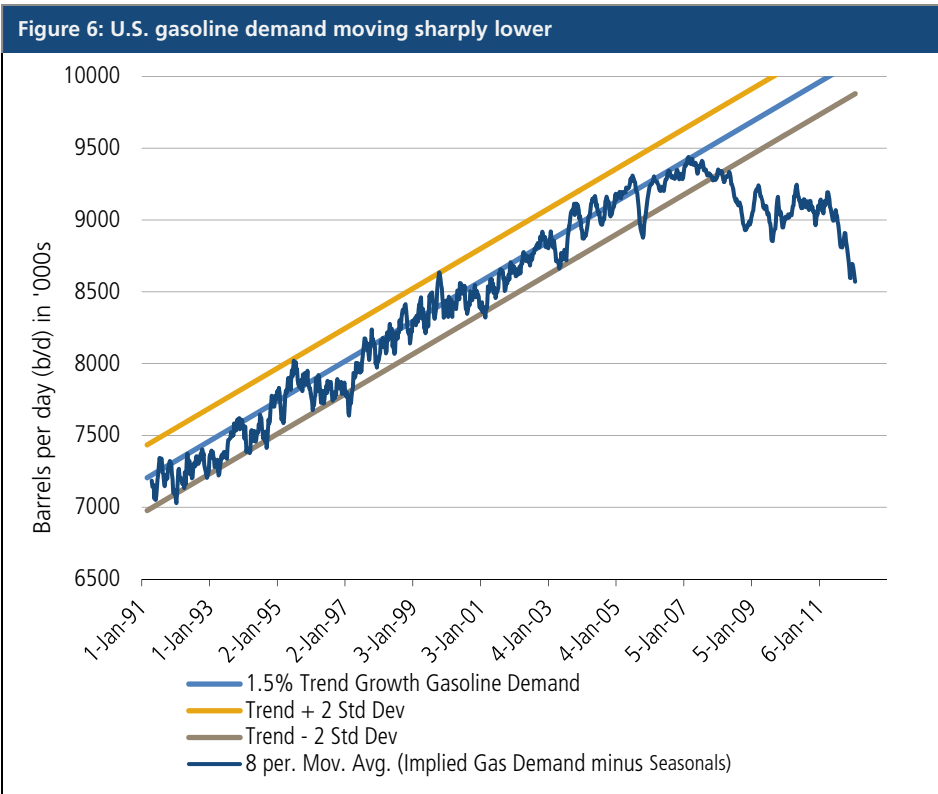
currently or in the past because of the long pass-through time before changes in initial conditions show up in retail prices. Based on current conditions in these sectors, we do not expect much price pressure from these categories that were so important in 2011. That leaves us with the price of oil – a category that tends to be volatile, difficult to model and yet has an instantaneous effect on inflation via the price of gasoline at the pump. Below we share our thoughts about our oil outlook for 2012 and its potential impact on inflation.

Perhaps the two most important things to say about oil is that Libyan production is coming back faster than expected (Figure 5) and gasoline consumption in the U.S. is declining at a dramatic pace (Figure 6). Easing pressures from both the supply and demand side lead us to conclude that, absent renewed geopolitical pressures, oil price rises are likely to be subdued in 2012 and not a large contributor to inflation.

Figure 5: Libya coming back should ease some tightness in oil markets

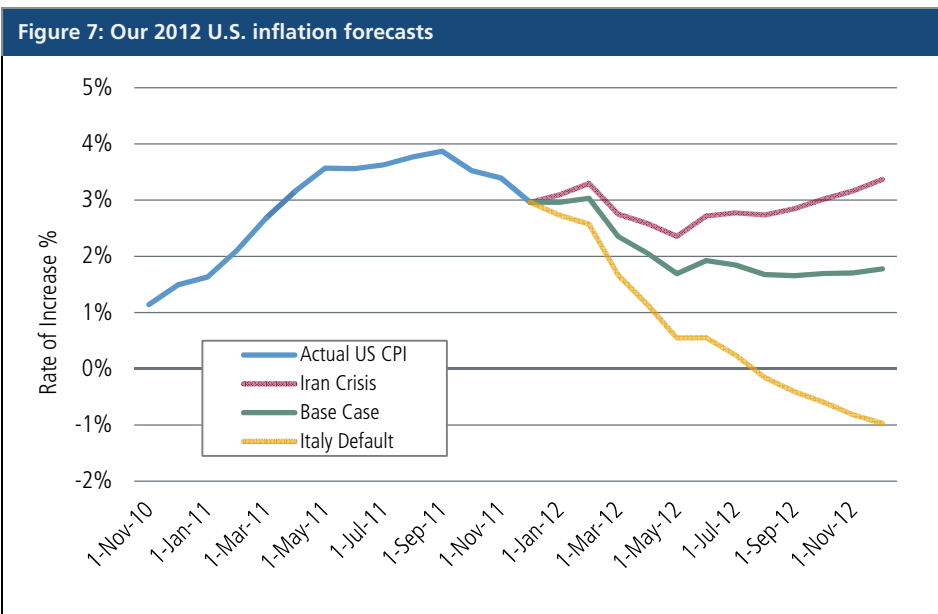


Source: International Energy Agency, PIMCO. Data as of 15 January 2012. Future data are PIMCO forecast.



Source: U.S. Department of Energy, PIMCO. Data as of 31 January 2012.

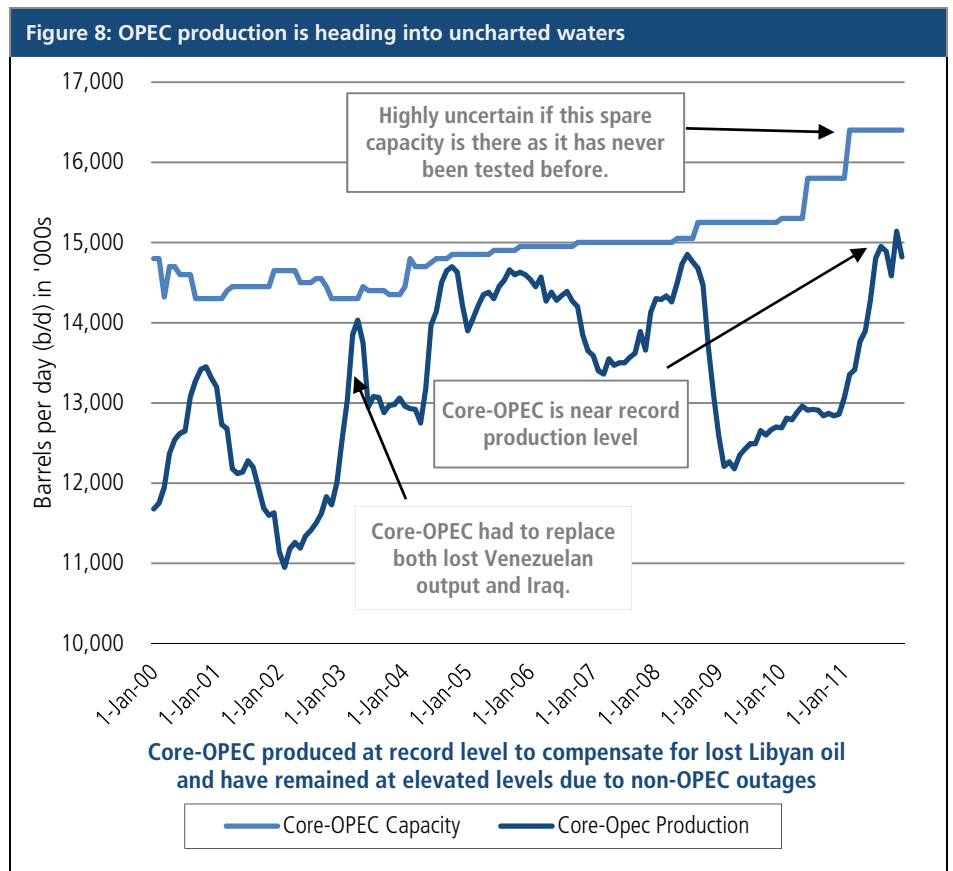
Combining our base case outlook for oil along with the other components that make up the CPI basket results in our central forecast for inflation to come in just below 2.0% in 2012, as shown by the center green line in Figure 7.



Source: U.S. Bureau of Labor Statistics, PIMCO. Data as of 31 January 2012. Future data for 2012 is PIMCO forecast.

Beneath this seemingly benign outlook are a number of important and volatile factors visible if you look just below the surface. Most urgent are geopolitical tensions in the Middle East and the economic crisis in Europe.

While Libyan production is coming back online at a very rapid pace, the oil market remains remarkably tight (Figure 8). Inventories are well below the five-year average level, and there is little spare capacity across OPEC producers. Furthermore, the spare capacity that exists has not been previously tested. The oil supply chain is tight, which leads to the possibility for potential upside relative to our baseline inflation forecast given further supply disruption. The possibility of an interruption in exports from Iran remains the highest probability, in our opinion.



Source: International Energy Agency, PIMCO. Data as of 15 January 2012

On the other hand, should the European debt crisis result in a global recession, the global demand for oil would likely be negatively impacted. The collective action of OPEC producers removing oil from the market could help to put a soft floor under oil prices, but there still remains considerable downside risk from current prices. As shown previously, Figure 7 illustrates the deviations from our baseline forecast due to these two factors. The red line illustrates possible upside surprise due to an event in Iran while the yellow line is our expectations for the downside shock should a major European country like Italy default.

Longer term

Moving beyond the next year, we see a number of inflationary pressures building in the economy. The Fed has committed to maintaining real short-term interest rates at negative levels for the foreseeable future and has also marginally increased its inflation target to 2.0% from a prior range of 1.7% to 2.0%. Increased attractiveness of real assets and a weaker dollar are likely results of such policy. Meanwhile, we believe continued emerging market growth and stretched supply chains should result in persistent upward pressures on commodity prices. Finally, political trends like the bias towards deglobalization, isolationism and wealth redistribution, on the margin, all point toward generally higher prices, rather than lower.

Faced with this possibility of higher inflation in the future, many investors may need to examine their allocations to assets associated with real return potential, including Treasury Inflation-Protected Securities (TIPS), real estate, commodities and equities. In particular, the current market for TIPS reflects modest inflation expectations. Given our outlook of potentially higher inflation over the longer horizon, we feel TIPS remain attractive for a real asset allocation, especially as they are backed by the full faith and credit of the U.S. government.

Past performance is not a guarantee or a reliable indicator of future results. All investments contain risk and may lose value. **Equities** may decline in value due to both real and perceived general market, economic, and industry conditions. **Inflation-linked bonds (ILBs)** issued by a government are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Treasury Inflation-Protected Securities (TIPS) are ILBs issued by the U.S. Government. **Commodities** contain heightened risk including market, political, regulatory, and natural conditions, and may not be suitable for all investors. The value of **real estate** and portfolios that invest in real estate may fluctuate due to: losses from casualty or condemnation, changes in local and general economic conditions, supply and demand, interest rates, property tax rates, regulatory limitations on rents, zoning laws, and operating expenses. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market.

The Consumer Price Index (CPI) is an unmanaged index representing the rate of inflation of the U.S. consumer prices as determined by the U.S. Department of Labor Statistics. There can be no guarantee that the CPI or other indexes will reflect the exact level of inflation at any given time. It is not possible to invest directly in an unmanaged index.

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840 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

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