

## Too Much!

(The weak dollar – causes and consequences)

John Snow and Alan Greenspan have finally bowed to the inevitable. Instead of blocking the lane in defense of a Shaq Attack slam dunk, they have politely if somewhat obfuscatingly stepped aside. “Put it down brother” they seem to be saying, but it’s the dollar and not a round ball that they’re referring to. The dollar has gone down. The dollar is going down. The dollar will continue to go down because it’s the easiest way out (for the U.S.) to begin to rectify its imbalanced finance-based economy. Balance the budget? Fugitaboutit. Raise interest rates to historic norms? Fugitaboutthattoo. “Let the market decide,” Snow says. “Likewise,” chimes Greenspan, warning that sooner or later foreign lenders

will not be so exuberant in their purchase of U.S. Treasury bonds. Perhaps they’ll be a little less “irrational” with their money he might have thought, but that’s a word he doesn’t use anymore. And so the market’s most crowded trade – short the dollar – will inevitably become a little more crowded, perhaps “irrational” itself at some point. There is a whiff of crisis in the air.

How the world came to this point is well documented in some journals, including this one, but it bears repeating if only to reacquaint pre-Alzheimer candidates and those with “senior moments” such as myself with the facts. The U.S. spends too much; eats too much; drinks too much;

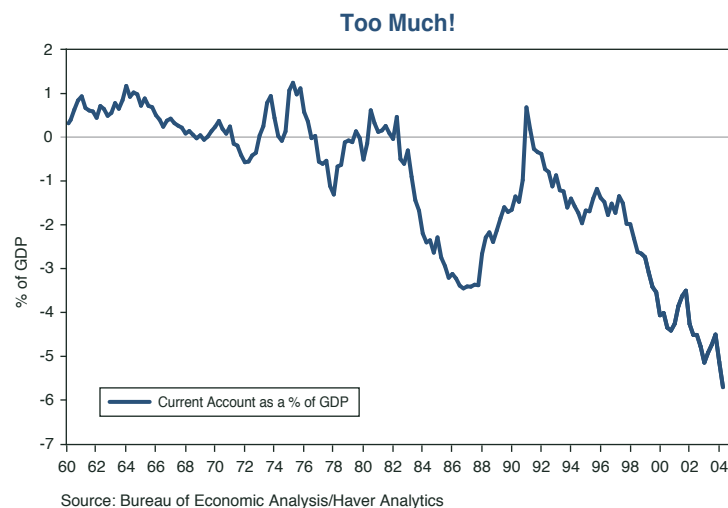


Chart I

TOO MUCH, (thank you Dave Matthews). And we pay for it with our debt and 80% of the world's excess savings. In so doing our creepy crawly balance of payments deficit has inched its way up to 6% of GDP – a level never seen in the U.S. and reflective of third world nations in financial crisis. The imbalance has been tolerated by those nations on the surplus side of the ledger – read “Asia” – in a strange sort of mercantilistic Faustian bargain that promises China and Japan the benefits of a strengthening economy now for the perfidy of falling dollar denominated Treasuries bonds later, an arrangement that once again will prove that there is no free lunch, or that hell often follows heaven on Earth.

There are those that argue that this tidy little bargain between debtor and creditor nations can go on for a long, long time. Since each party gets what they want – the U.S. to consume, and Asia to produce – who's to say when the first player will opt out? For now, China's rather introverted geopolitik allows them the flexibility to revalue their Yuan whenever they damn well please as long as their inflation rate behaves. Japan is beholden to the U.S. militarily and continues to struggle with deflationary pressures. That argues for at least jawboning its Yen lower. “Dirty float” is and likely will remain synonymous with Japanese forex policy. So there seems no immediate incentive for either China or Japan to opt out of their Faustian bargain. On the debtor side, the U.S. will shop “til it drops – pure and simple but that phrase up until now has always accentuated the “shop” and conveniently forgotten about the “drop.” The drop comes when this comfy cozy current relationship between giver/taker, consumer/maker for some reason ends in divorce. The only ques-

tion is one of timing. At some point, as Greenspan so astutely pointed out, “foreign lenders will eventually resist lending more money to the United States, causing the dollar to drop further.” What he didn't say is that will be the point when the shopping stops and the fun goes out of a trip to the mall. That's the point when U.S. inflation heads gradually but inevitably higher, and that's the point, of course when interest rates move into harm's way.

If it seems strange that Treasury Secretary Snow and Fed Chairman Greenspan are actually encouraging this weak dollar policy, one can rationalize that they've seen the end game and they want to ease their way around the pileup. Better to talk the dollar down now before the balance of payments gets so bad that a true crisis is inevitable. I cannot disagree. And as mentioned in my opening paragraph, alternative solutions to the problem are “pie in the sky” unimaginable. For Americans voluntarily to begin to get the old time religion of saving more money is beyond dreaming, especially with employment so weak and the source of historic capital gains – stocks and houses – still above cost. Likewise a Bush Administration seems unlikely to move towards a more balanced budget with its aggressive legislative agenda which includes social security reform. Optimists tout the escape route of faster foreign growth to suck up American exports but Europe has caught a congenital case of influenza, Japan is back to the zero growth line and China is maneuvering for a soft landing.

My point is this: dollar depreciation now, and Chinese Yuan revaluation as soon as possible is the easiest first step to rebalance an imbalanced U.S./global economy. This realization is and has been as close to

a slam-dunk as we have seen in the world of finance; slam-dunkier than calling the stock market top at NASDAQ 5000 or Soros breaking the Pound Sterling. You can count on it (the Dollar going down against Asia)– not that there won't be frantic short squeeze reverses even as this Outlook is being written, or that against some currencies (the Euro) the U.S. dollar actually may be cheap.

But how best to profit from it? Like I'm fond of telling my fellow PIMCO portfolio managers as they pontificate about the future of the economy, "You can't invest in GDP futures, what are the investment implications?" Granted, some of you readers can or have already joined the trash party and are short the dollar. We can as well and have done so in minor amounts. But currencies are not the game for which we were hired. They go up and down quicker than 30-year 0's and can ruin or make your day/year/career. And aside from the obvious benefits that a declining dollar imparts

to gold and commodity prices, the focus of this *Outlook* should be on bonds. What bonds should be bought or sold? I have several specific thoughts:

- 1) As long as the Euro strengthens against the dollar, there is reason to favor German Bunds instead of U.S. Treasuries. We have recently reduced some of our positions but remain confident that the inflationary impact of a weaker dollar and the disinflationary benefit of a stronger Euro favor Bund/Euroland positions. A 10% decline in the trade weighted dollar according to our calculations increases U.S. inflation by approximately ½% over the ensuing 24 months. While a strengthening Euro/dollar relationship has a positive disinflationary impact in Euroland, it will unquestionably not be the inverse of the U.S. due to the smaller dollar impact on their trade weighted currency. But as Chart II

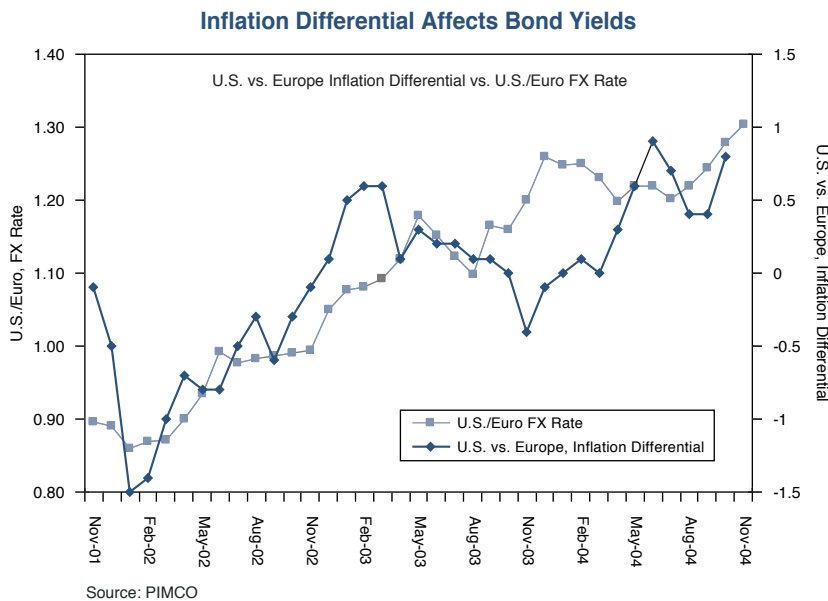


Chart II

shows, the inflation differential in the short run may be as high as  $\frac{3}{4}\%$  in favor of Euroland with the Euro at its current 1.30 level. Because the Euro has appreciated inordinately as Asia has controlled their own currencies, I would be leery of Bunds when and if China revalues. That point, however, may be months ahead.

- 2) Buy TIPS. I've said this before when discussing U.S. reflationary tendencies. Since a declining dollar is perhaps the most quantifiable of all reflationary weapons –  $\frac{1}{2}\%$  higher inflation per every 10% trade weighted dollar decline – the benefit should accrue to short maturity TIPS on an almost one for one basis and to 5-10 year intermediate TIPS in smaller proportions.
- 3) Be careful with U.S. Treasuries. I offer a word of caution here if only because of a strange rather unquantifiable twist in the balance of payments saga. While Greenspan has correctly suggested that foreign private institutions and central banks will not lend at the current pace forever because of a burdensome trade deficit, there is the probability that until the first sizeable creditor turns tail that an accelerating deficit actually lowers interest rates. Think about it: For every dollar we spend on imports, that buck comes straight back to us (for now) in the form of a Treasury buy ticket. So the more we spend on imports in the short run, the more we save. Sounds like my wife at a sale, but it makes sense as long as foreign creditors buy longer dated Treasuries. Purchases

of intermediate and long maturity Treasuries reflect a confidence in the fiscal/monetary stability of the U.S. economy. When that confidence disappears, foreign purchases take the form of overnight deposits as the buck is tossed from one holder to another like a hot potato. That's when the dollar tanks, the balance of payments deficit eases back towards 2 or 3% and perversely, intermediate and long-term interest rates are more susceptible to going up. To sum up this CATCH 22, a deteriorating balance of payments deficit may actually have a positive effect leading to lower interest rates until a large creditor turns tail. It's another way of saying that U.S. yields depend upon the kindness of strangers and that the time to not own them is when the strangers become less kind. I suspect that is just around the corner but Beijing and Tokyo have the ball in their courts.

Wherever that should occur, there's no doubt that the dollar is on the run and that higher U.S. interest rates are the inevitable consequence. Dollar depreciation leads to higher inflation and ultimately forces foreign creditors to question their rationale and indeed their sanity for continuing purchases of U.S. Treasuries. Investors don't need necessarily "TOO MUCH" intelligence to do this trade. Rather, they may need lots of patience in order to turn it into a profitable, near slam dunk opportunity.

William H. Gross  
Managing Director

P I M C O

840 Newport Center Drive  
Newport Beach, CA 92660

949.720.6000

**Past performance is no guarantee of future results.** The charts portrayed in this article are not indicative of the past or future performance of any PIMCO product. This article contains the current opinions of the author and such opinions are subject to change without notice. This article has been distributed for informational purposes only and is not a recommendation or offer of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

Each sector of the bond market entails risk. Inflation-indexed bonds issued by the U.S. Government, also known as TIPS, are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation. Repayment upon maturity of the original principal as adjusted for inflation is guaranteed by the U.S. Government. Neither the current market value of inflation-indexed bonds nor the value a portfolio that invests in inflation-indexed bonds is guaranteed, and either or both may fluctuate. Investing in non-U.S. securities may entail higher risk due to non-U.S. currency fluctuations and political or economic uncertainty and may be enhanced when investing in emerging markets.

No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC. ©2004, PIMCO.