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Investment Outlook

P I M C O

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The 5% Solution

Is the Fed impotent now – a 110-pound weakling getting sand kicked in its face by the global financial community as it creates massive liquidity? Or to put it more politely, can Bernanke continue to control the U.S. economy and inflation – or is he, like everyone else, at the mercy of the recycling of Asian and BRIC reserves, the reinvestment of petrodollars, and the hardnosed capitalistic proclivities of hedge funds and investment banks? It's not an outrageous question you know, and its answer may help guide asset managers in their quest for profits in 2007 and beyond. Even the Fed itself has admitted that it sometimes resembles Nicole Richie as opposed to Arnold Schwarzenegger these days. After all it was Ben Bernanke who coined the phrase "global savings glut" and used it to explain why intermediate and long-term yields in the U.S. (and by implication worldwide) were as much as 1% lower than they should be. Still, while a case can be made that much of the U.S. and other global yield curves have been almost permanently reshaped by yield insensitive recycling of U.S. balance of payment deficits, it seems to me that the Fed actually has a stronger hand to play in 2007 than it has for several years now and that determining where the future Fed Funds rate should

be is a key for bond and stock market performance in the months and quarters ahead. With Asian central banks more concerned about currency levels than reinvestment returns, petrodollar recipients more worried about parking their burgeoning wealth in perceived safe haven bond markets than debating whether the U.S. 10-year belongs at 4.7% or 5.7%, and multinational corporations still leery of deploying their huge cash reserves in capital spending alternatives, the one and perhaps only major player that is particularly price sensitive is the Fed. If 5¼% is the right rate for a goldilocks economy then there it will stay. If it generates accelerating inflation then it'll go up; if accelerating unemployment then it'll go down. And because the Fed is the most price-sensitive participant in the credit markets they, not private market players, will guide other yields upward or downward much like the North Star has guided mariners for centuries. Where, then, will Fed Funds be at the end of 2007?

Rather than digress into a micro discussion of the U.S. housing market and implications for a growth "disconnect" between the American and global economies, I find it most helpful to analyze the current restrictiveness of 5¼% short-

term yields by comparing that benchmark to the growth rate of nominal GDP. Many investment managers are almost oblivious to nominal U.S. GDP levels these days – as a matter of fact, the Commerce department itself nearly buries the nominal number 8 or 9 paragraphs deep in its quarterly press releases. There are times when you can't even find it in the text. But it is nominal, not real GDP that reflects the return on a nation's capital, and nominal GDP that points towards our ability to pay our bills. Since almost all yields reflect a real plus an inflationary component, it stands to reason that the ability to pay debts expressed in nominal terms should be viewed in a similar fashion when analyzing growth. By so doing one can understand, for instance, why a deflationary environment can be so deadly to a modern-day, debt-laden economy. It might be growing in real terms, but if nominal growth sinks below the zero line then the servicing of debts becomes onerous and can lead to liquidity traps that implode financial markets.

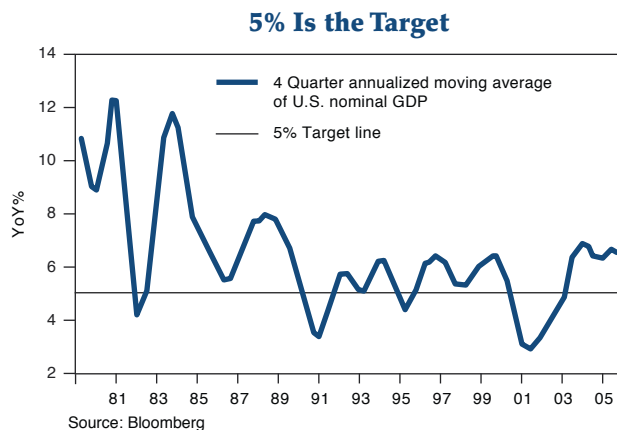


Chart 1

Nominal GDP levels are so important to the Fed in fact, that there are rather explicit although slowly changing levels of growth below which the Fed cannot allow them to sink for an extended period of time – lest recession rear its ugly head. While Chart 1 points out that in the 1980s high single-digit, even double-digit growth rates were the norm, over the past 15 years or so, the U.S. economy has gravitated to an average nominal growth rate of 5% or so as disinflation has taken hold. Because 5% has become so “standardized,” government, mortgage, and corporate bond yields have centered around that level as well – the Lehman Aggregate index now yielding approximately 5.30%. 5% is how fast we grow and 5% is what we owe; the two rates are thus symbiotic, one feeding off the other when the economy is in balance. Problems arise however when nominal growth rises too far above 5% - reflecting most probably accelerating inflation – or too far below 5% - usually indicative of declining real growth. When it moves in either direction for a period of several quarters the Fed moves with it, raising rates to quell inflation or lowering rates to support real economic growth and employment. Due to leads and lags, it's usually the nominal economy that dictates what the Fed must do, and when the Fed responds accordingly, 12-18 months later the economy reverses which in turn affects the Fed in this never-ending circle of cause and effect, chicken and egg. As Chart 2 demonstrates, when the nominal economy sank below 5% in

January of 2001, the Fed almost immediately reacted by lowering yields to insure the economy's revival a year or so later. Readers will remember that although that period's "recession" was a brief and mild one just barely below 0% in real growth terms for 3 quarters, the nominal rate approached 3% - a 2% deviation from the standard 5% rate that marks the U.S. economy's nominal growth rate required to service its debts. By so doing, the Fed was forced to massively respond by eventually targeting overnight funds at the 1% level. Similarly during the past few years' recovery with levels of nominal GDP approaching 7%, the Fed raised rates by over 400 basis points to dampen the inflationary reflex.

"Dampen" the reflex it has, along with producing lower real growth, such that nominal GDP in the 3rd quarter of 2006 hit an annualized level of just 3.8%. Admittedly, one quarter does not a Fed decision make, but hypothesize with me for a second what Fed Funds rates we might encounter over the next 12 months as housing, reduced consumer spending, and lower levels of inflation affect nominal growth. It seems likely to me that 2% real growth and 2% inflation or some plus/minus combination of the two are leading us to 4% nominal GDP levels in 2007. While that may seem like Goldilocks to some - especially those who exclusively follow real GDP levels - it is not enough to support an asset-based economy which has built in costs of debt averaging 5%+. Should the economy slow to 4% nominal without

a downward Fed Funds response, then stock and housing prices will likely move lower as well. Examine Chart 2, which displays periods of time during which Fed Funds exceeded nominal GDP by 1% or more, producing a resultant nominal GDP of 4% or less. Three periods in the last 15 years - 1990, 1995, and 2001 (marked by a * in the chart) - were accompanied by either declining stock prices, declining real house prices, or both. The reason is that whenever the cost of capital (Fed Funds) moves above the return on capital (Nominal GDP) then assets dependent on leverage (stocks, houses) suffer negative or more restrictive cash flows and are liquidated at the margin. In order to minimize the damage the Fed responds by lowering its cost of capital to at least 100 basis points below nominal GDP as in 1996 or by as much as 250-500 basis points below as in 1993 or 2003. If 4% nominal GDP is where the U.S. economy is headed over the next 12 months then historical analysis might imply eventual Fed Funds levels of 3% and lower.

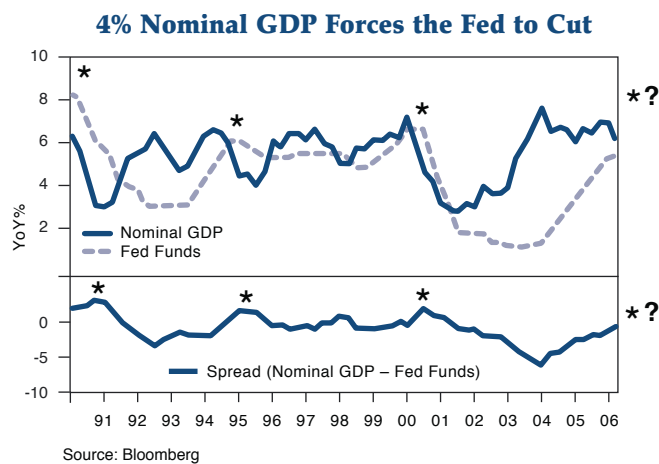


Chart 2

Admittedly much has changed since the early 1990s or even over the past 5 years. Ben Bernanke's savings glut has not only lowered all yields 100 basis points or so below historical norms, but the globalized economy which produced it appears to have a life of its own, relatively unaffected to date by the U.S. housing market and consumption implications. If so, then one might expect global growth (with its American export demand) to exert a moderating upward influence on U.S. nominal GDP growth rates. Still, if 5% is the magic number and 4% is where we're likely to hang out in 2007, then the Fed will likely respond sometime within the next six months with a series of cuts intended to restimulate growth along with its key asset markets (primarily housing). What will be perhaps most interesting to observe in 2007 is not the level of Fed Funds by yearend, but whether or not the series of cuts has been successful in reattaining that required 5% growth rate. If homeowners do not take the bait and restart the summer/fall/winter/spring cycle typical of asset markets, then Fed Funds expectations will move lower still, no matter what the global growth scenario.

We at PIMCO look for a Fed Funds rate of 4¼% by December of 2007 with 5 and

10 year yields hovering at levels perhaps 25 basis points higher. While that by no means would be reflective of past bond bull markets in terms of magnitude, that is not to imply that 12/31/07 would mark its last gasp. With nominal growth in the U.S. economy dependent on asset appreciation more than ever before, the Fed will lower rates as far as they must in order to produce it. We, like everyone else, will be interested observers along that downward path as they attempt to push the nominal economy back to the magic 5% rate of growth necessary to pay this nation's bills. Is the Fed impotent now? Not as powerful as it once was, but with private financial market participants more interested in other pursuits, it may be the only game in town, at least for 2007, and if it lowers rates sometime within the next six months then the U.S. bond bull market will gain renewed vigor.

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