

Back to the Garden

We are stardust

We are golden

We are billion-year-old carbon

And we've got to get ourselves

Back to the garden

Woodstock: Crosby, Stills and Nash

The Earth can be a cold orb, especially when viewed from a scientist's instead of a theologian's eye. Copernicus, for example, squashed the concept of our planet as the center of the universe surrounded by God's heavens, Darwin introduced doubt as to the factual instead of the mythological concept of Adam and Eve, and in the early 70s, many academics were even proclaiming that God was dead – admittedly a metaphor in itself, but cold and frightening nonetheless. It is refreshing, therefore in this modern age of singularities, string theory with its twelve dimensions, and quantum physics posing the “now it's there, now it's not” phantasm to read a bit of science that offers some hope as to life and the hereafter – if only in an atomical sense.

Author Bill Bryson in his book *A Short History of Nearly Everything* illuminates – well – just about everything you ever wanted to know about science. His chapter on the “Mighty Atom” speaks to the reincarnation of the body, not in a Buddhist or even a Catholic sense of the body transcending to heaven, but from a purely scientific perspective. We are all reincarnations – though short lived ones, he/the scientists claim. “When we die our atoms disassemble and move on to find new uses elsewhere – as part of a leaf or other human being or drop of dew... We are each so atomically numerous and so vigorously

recycled at death that a significant number of our atoms – up to a billion for each of us, probably belonged once to Shakespeare. A billion more each came from Genghis Khan and Beethoven”... although to be fair, we are not yet one with Elvis – leave that to our great grandsons and granddaughters. Turns out I guess that David Crosby in his late 60s golden oldie cited above was right after all: We are stardust, we are golden, even if we're not yet Elvis.

Still this realization, while fascinating, leaves me as frozen as a molecule of H₂O in a Sub-Zero unless one takes the additional leap from the cold hard scientific fact to the metaphysical. Seems that Crosby, Stills & Nash did as well: in their song's next line they proclaim that “we've got to get ourselves...back to the Garr arr arr arr deeeeen.” (they stretched out the “Garden” part dear reader in case you forget the song). My first thought when contemplating these words at 60 was one of sheer envy. How did they figure it out in their 20s and I'm heading into my fourth score of years and just now getting a clue? But I digress. What was it about the mythological Garden of Eden that they wanted to get back to and what does it have to do with stardust? Well, as American author and teacher Joseph Campbell points out, the Garden was a place of oneness, of unity, of no divisions in the nature of people or

things. And as Bryson elaborates, we're all made from the same atoms – Beethoven's, Shakespeare's, Alpha Centauri's: stardust. Understanding that scientific fact can at least point us in the direction of the Garden. By finding it again, perhaps we would experience a oneness with nature and things, and just as importantly, a oneness with each other. How dare we behead hostage after hostage in Iraq. How dare we kill ourselves in Jerusalem and Gaza with the Garden so tantalizingly nearby. How dare we suffer Somalia and Sudan with hundreds of thousands of us dead from tribal genocide. How dare we _____ (fill in your own). We are all stardust, we are all golden, and we've got to get ourselves back to the "Garr arr arr deeeen."

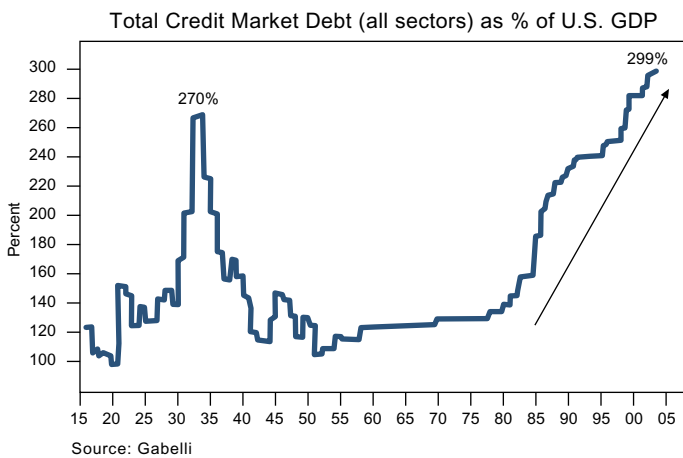
Well, I being you and you being me, I guess we created quite a stir with our interview printed in the *Financial Times* a few weeks ago. Like the doomsayers we are, we stated that the global economy was more imbalanced than at anytime in the last 25-30 years (the early 70s and the fall of Bretton Woods, the rise of OPEC, and the slicing of the U.S. stock market in half being the supercedent). That thought was a direct offshoot from our May Secular Forum and the "Circus Game"/wire walking theme in last month's *Investment Outlook*. Still a little further elaboration might be in order as we try to get ourselves back to the Garden of investing, searching for oneness, and the Holy Grail of the perfect portfolio.

It seems to a lot of economists/investors that we've rarely been in a more balanced economy. GDP in the U.S. is growing at 4%; productivity is high; inflation is low; job growth is resuming. Well yes – for now. But my comments were a precautionary foghorn on a sea with a seemingly clear

horizon, suggesting that if the weather changed then a financial and economic shipwreck was a possibility. But forecasting Armageddon is a tricky business. Mankind's indominatably optimistic spirit has a habit of postponing foggy days until the gloomster's warnings and ultimate sanity is called into question. Crying wolf must be done infrequently and with relatively precise timing to be effective. I shall try to follow my own advice.

The debate I helped foster over a balanced vs. imbalanced global economy revolves around the fundamental proposition that bad things can happen in a levered economy. Think of two garages – one with two cars and an immaculately swept floor and the other filled with boxes, newspapers, paint cans and numerous oily rags. Which one do you think has the better chance of going up in flames if a match or a faulty electrical wire creates Fahrenheit 451? That is an apt metaphor in economic terms when comparing a healthy non-debt laden economy to one thriving on the creation of paper and artificially low interest rates. To be realistic, the possibility of matches and faulty wiring is ever-present and in retrospect, historically obvious. Geopolitical events such as the rise of OPEC in the 1970s, the Vietnam War, and 9/11 have always served as inflationary and in some cases recessionary sparks in an economic context. And fiscal and monetary policy mistakes surrounding these and other independent cyclical trends have accentuated the damage. No Fed Chairman, or President intent upon reelection has ever been immune to minor and in some cases grievous errors of judgment. Rates too high or too low for too long for instance; deficits or fiscal surpluses at exactly the wrong time in the business cycle for another. But a geopolitical or

policy match can be thrown onto a spotless garage floor with little chance of a major calamity. With debt laden oily rags strewn throughout, however, the probabilities change. The chart depicted below and as shown in previous *Investment Outlooks*, therefore, is our major sin and largest stumbling block in any attempt to get back to the Garden of economic prosperity and attractive investment returns.



The commonsensical explanation as to why, revolves around the observation that debt as opposed to equity requires an obligation to pay – principal at maturity, interest periodically – and when there’s too much of it the burden can be crushing if yields rise for geopolitical, policy mistake, or other imaginable reasons – one as simple as higher inflation for instance. In addition, problems arise when the maturity or distribution of the debt becomes imbalanced. Too much short-term as opposed to funded long-term debt has caused many a personal, corporate, and in some cases sovereign bankruptcy. And debt in the hands of benevolent instead of self-interested creditors can be crucial. Americans used to placate themselves with the adage that “we owe it to ourselves” when confronted with mounting public deficits. Such was the case

in the 30s, the burden of which was rather anemically molted away by subsequent inflation in the midst of interest rate ceilings imposed during WWII and its aftermath. But when over 50% of outstanding Federal debt is held by foreign creditors, then the rules of the game can change. Global current account imbalances reflected in our ongoing 5% of GDP trade deficit speak to dollar depreciation as a legitimate response to placate foreign creditors in need of a higher currency adjusted return on their “investments.” And if that dollar depreciation is significant, swift – or both – then economic and financial repercussions can follow a similar path.

The consequences of higher interest rates mentioned above can be destabilizing as well. It’s sobering to contemplate that not only has our current cyclical prosperity been due to the “productivity” of lower interest rates in a finance-based, debt-laden economy, but that the reversal of yields must be more than delicately manipulated in order to prevent reciprocal damage and global economic instability. I use the term global in this context more than figuratively. The reality is that almost all the world’s significant central banks save the ECB have begun or are in the process of monetary policy reversal and many do so within an environment fraught with substantial debt and therefore risk. England’s Monetary Policy Committee is already on the march upward in an effect to cool speculative housing appreciation. With home prices ultra-sensitive to short-term rates, however, they could go too high or stay too low, with their domestic economy swaying in the balance. Japan is contemplating an exit from their ZRP or Zero Interest Rate Policy. Talk about a

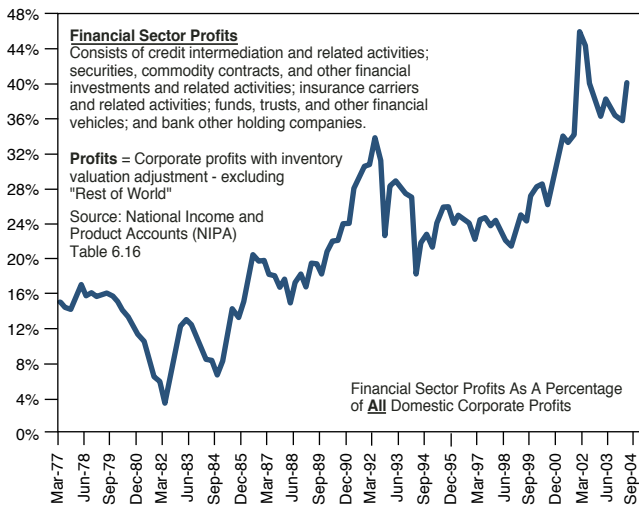
foggy horizon! With so much government debt held by so many domestic banks and insurance companies, their central bank could technically bankrupt their own financial sector by too precipitous a move which would sink JGB prices and asset valuations at these institutions. Japan's new friendly neighbor to the west – China – has a pickle with their own short-term rates and eventual revaluation of the RMB vs. the dollar. China's banks themselves have an excess of low quality loans supported by a thin thread of mercurial equity. And then there's the Fed. Wednesday's interest rate hike is just the beginning of a journey as to who knows where or when. Not only our housing market, but the financed-based profits (40% of all profits as shown below) of American corporations are at risk. This in turn speaks to the stock market, P/E ratios, and wealth/paper-based prosperity, that depend on the continued low cost of excessive debt taken on in recent years.

Because of these realities based on historically high levels of debt issued during a period of superficially low interest rates, the global economy is indeed in my view, more vulnerable than it has been for the past 25-30 years. The economic and investment consequences appear to be as follows: real short-term rates kept too low will create asset bubbles and accelerating inflation. Real yields raised too high will pop existing asset bubbles and lead to economic recession. The "Goldilocks" yield is the only one that speaks to relative stability, and the margin for error is much narrower than in prior decades. If bond investors are accepting of this thesis, they must acknowledge the uncertainty of their own portfolio structures. Accelerating inflation speaks to defensive durations and a healthy dose of TIPS. But potential recession at some point speaks to extended durations and a reemphasis on deflationary preventative interest rate policies similar to the past 24 months. While Greenspan

"speak" points towards gradual and measured hikes to return to a more neutral interest rate policy, he as well as other global central bank chieftains must acknowledge that "neutral" in a levered global economy is a yield shrouded by fog and fraught with uncertainty. The "Garr arr arr arr deeeen" of "financial and interest rate" Eden is out there somewhere but getting back to it may be almost as difficult as the return to our mythological one filled with oneness, unity, and love for one another.

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Financial Sector Breakdown



Source: Bianco Research, L.L.C.

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Each sector of the bond market entails risk. Municipals may realize gains and may incur a tax liability from time to time. The guarantee on Treasuries and Government Bonds is to the timely repayment of principal and interest, shares of a portfolio are not guaranteed. Mortgage-backed securities and Corporate Bonds may be sensitive to interest rates. When interest rates rise, the value of fixed income securities generally declines and there is no assurance that private guarantors or insurers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in non-U.S. securities may entail risk due to non-U.S. economic and political developments, which may be enhanced when investing in emerging markets. 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 of shares of a portfolio that invests in inflation-indexed bonds is guaranteed, and either or both may fluctuate.

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