



Circus Game

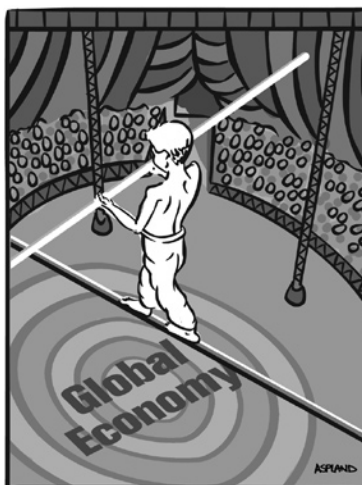
I'm up on a tightwire
One side's ice and one is fire
It's a circus game with you and me

"Tight Rope" by Leon Russell

Investing's a circus you know. Messrs. Barnum & Bailey probably wouldn't have had a clue as to what I'm talking about but the metaphor is more than apt. Every big top, you see, has a ringmaster who blows his whistle to begin or end the show (Greenspan), as well as its share of ferocious carnivores (portfolio managers). Then there're the jugglers (traders), clowns (those that buy at tops and sell at bottoms), and the inevitable entourage of elephants holding each other's tails (PIMCO's surely one of those, although it's hopefully the lead pachyderm – tail holding's a pretty stinky job). But during our three-day Secular Forum held in early May, PIMCO's 100+ professionals from around the globe took this circus metaphor to the very top of the tent.

"Cast your eyes ladies and gentleman up to the high wire more than 100 feet above the center ring. The death defying global economy will astound you by walking the wire between ice (deflation) and fire (inflation). It'll rebalance itself over the next 3-5 years before your very eyes, tiptoeing from a U.S.-centric global economy to one including Euroland, China, and its Asian neighbors. Truly the Greatest Show On Earth!"

Well...ringmasters (and Fed Chairmen) can be great salesmen at times. The art of hyperbole is a requirement of the job.



Our Secular Forum participants, with perhaps a slightly more down to earth view, would readily concede that investing's a circus and even that the global economy is successfully walking a high wire, for now. We're just not as confident of the health of our global economic walker's inner ear – call it his sense of balance – and whether he might not tip

first in one direction (fire/inflation) and then another (ice/deflation) and eventually crash to the ground. Read on, dear reader – let the circus begin.

Historical Secular Review

Last year's Secular show, if you'll recall, was dominated by a sense of a global economy in recovery due to near historic amounts of fiscal and monetary stimulation. We alluded to our 3-5 year outlook, however, as a "wet log" fire, recognizing the potency of 1% interest rates and \$500 billion deficits in the U.S., but insisting nonetheless that in the out years – 2006 and 2007 – that the world's economy would revert to a simmering (not smoldering) relic of its former self as the stimulus wore off and the primary macroeconomic problem returned: a lack of aggregate demand and too much supply. Because of globalization and Chinese overproduction; because of private debt levels and their eventual suffocating impact on personal

spending; because of a creeping almost imperceptible demographic muting of consumption in aging societies such as Japan, Germany, and Italy; because of market bubble popping; and because of post 9/11 syndrome and other terror related influences, we felt we were living in a world where we had too much relative to what we can afford to or want to spend. Slow growth would dominate. Inflation would be contained.

Current Outlook

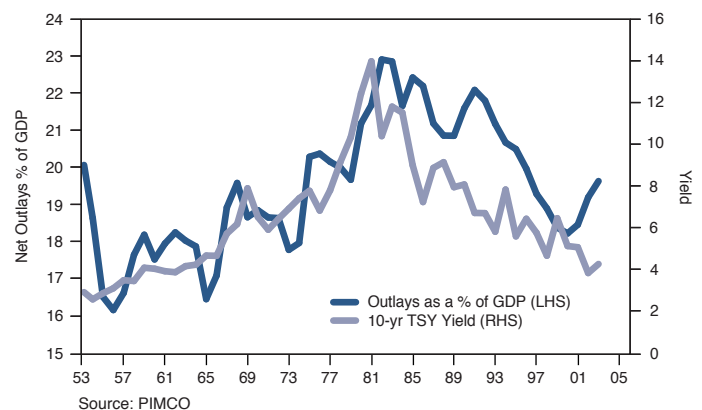
Into this potentially tepid fire stepped a brand new set of Forum guest presenters with a fresh set of observations on our developing secular scenario. Economist/journalist Martin Wolf of the *Financial Times*, author Amy Chua, Forum veterans Stephen Roach and Andy Xie from Morgan Stanley, and Niall Ferguson of *The Cash Nexus* and *Colossus* renown, who seemed to know more history than his 40 years could possibly have allowed, reminded us that much had changed in the past 12 months, even if our focus was on the next 3-5 years. The changes include:

- 1) A rapid disappearance of the U.S. fiscal peace dividend and an accompanying extended timeframe for the Iraq/U.S. war against terror.
- 2) Increasing imbalances of overseas trade and/or financial surpluses. (Japanese and Chinese accumulation of Treasury paper).
- 3) A deteriorating global image of the United States, which could impact the spread of the American capitalistic model to venues such as trade talks and OPEC meetings.
- 4) Confirmation of a reactive as opposed to a formerly proactive Fed.

5) The inclusion of 10 new countries into the European Union.

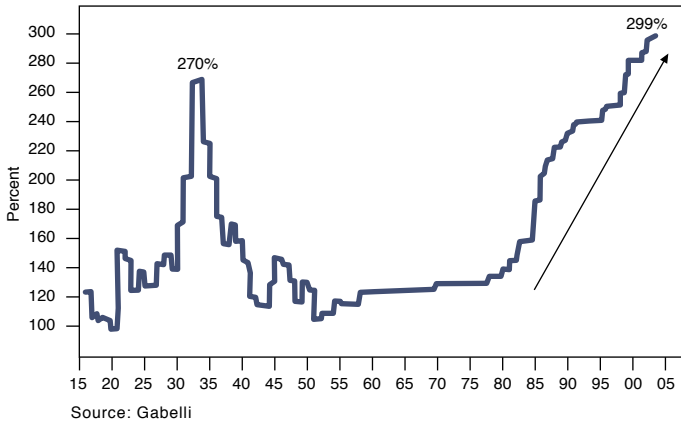
With the exception of #5, all of the above changes fall squarely into the corner of increased government control and a diminishing influence of Adam Smith's and capitalism's invisible hand. PIMCO's Paul McCulley has for some months argued that the iron fist of government was becoming increasingly prominent as the United States begins to refocus on the democratic principle of one person/one vote as opposed to the capitalistic principle of one dollar/one vote. We are in his and PIMCO's opinion beginning an almost imperceptible shift from making the economic pie bigger to deciding how to divvy up the proceeds. If so, that is to predict that tax rates are at their ebb, that fiscal deficits as opposed to the Clinton surpluses will dominate our future, and that labor/employment will be our primary domestic economic focus in years to come. Accordingly, we hypothesize with much historical backing that while capitalism promotes disinflation (1980-2000), democracy promotes inflation (1960-1979). A chart provided by PIMCO's Mark Kiesel points out as well, that as government spending increases as a % of GDP, interest rates move higher.

U.S. Government Net Outlays & UST 10-yr Yields



The economic rationale for increasing government involvement is that our capitalistic model is extended and highly levered – much as it was in the late 1920s –

Total Credit Market Debt (all sectors) as % of U.S. GDP



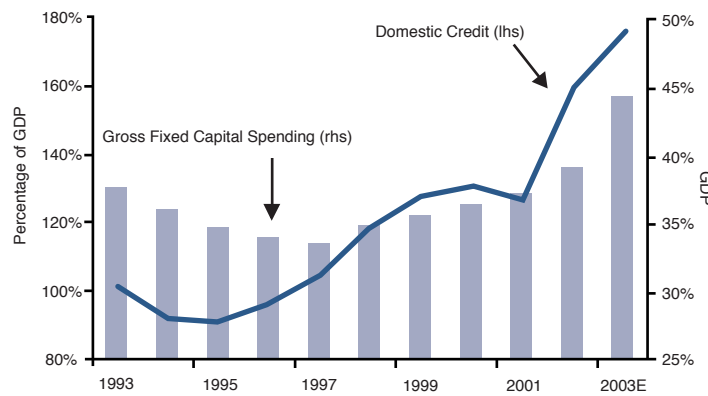
and that following such periods it has been the accepted Keynesian model to substitute government demand/control for weakness in the private sector. We apparently came close to the perilous rocks of deflation during the past 12 months and so the printing presses rolled out the hundred dollar bills in the form of 1% Fed Funds, and sound fiscal policy gave way to a \$500 billion deficit. In addition, a trend towards reregulation and away from the deregulation/disinflation of the past several decades has been apparent via the ongoing litigation across the securities industry, implementation of Sarbanes-Oxley over the entire public corporate sector, minor erosions of free trade principles via implementation of steel and lumber tariffs, and the marginal loss of personal freedoms due to terrorist legislation.

U.S. Government, then, in PIMCO's view is in the ascendancy and will seek to redistribute

wealth in future years that will have an inflationary bias. We note that in Euro-land (in contrast to the U.K.), trends remain pointed towards less and not more government involvement although they admittedly start from a much higher base. A potential solution to our high wire global balancing act is for Euroland to become more capitalistic and therefore more growth oriented. Their feeble trends towards deregulation and their more sound (although still high) fiscal deficits are an attempt to do so. Whether or not they succeed is perhaps guesswork at this point, but a more Euroland-centric economic push is definitely one of the requirements if the global economy is to successfully walk the wire.

Necessary as well will be the continued stable climb of Asia/Japan. Morgan Stanley's Roach and Xie are rather adamant in their belief that a significant slowdown is underway there and will continue for at least 2004, although the longer term looks better. China, says Roach, is more highly levered than the U.S. economy – 200% debt to GDP by crude estimates – and that leverage is most prominently expressed via the

China's Domestic Investment & Credit Outstanding, 1993-2003E (% of GDP)



property market. It is that, as well as the unsustainable surge in investment shown in the accompanying chart that represents risk, with its bubble popping ramifications.

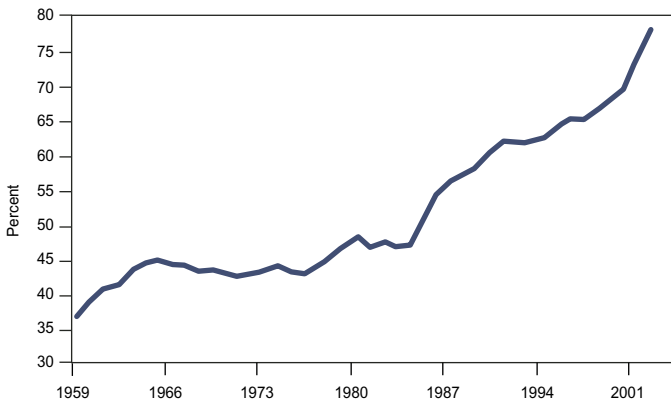
While China still only accounts for 4% of global GDP, it consumes tremendous amounts of commodities and other nations' exports at the margin – 20-30% of the world's cement, nearly as much steel, coal, and iron ore, and 7% of all the oil. Increasingly, as China goes, so goes the rest of the world, especially its Asian neighbors and Japan. Estimates are that 40-50% of Japanese growth is China-centric. A Chinese slowdown of some magnitude will be a challenging development for the Land of the (recently) Rising Sun.

Even if China stabilizes at a relatively high growth rate following credit and investment controls, there remains a perplexing secular problem in China that strikes at the heart of the global economy's attempt to balance production and consumption. That dilemma after all has been central to our argument for "wet logs" in the past few years, and as we shift to a new metaphor, it is apparent that China/Asia holds a key to successful wire walking as well. With Europe and the U.S. heading towards either a demographically or finance induced savings mode, it would be hoped that the 1.2 billion potential consumers in China (and 1 billion in India) would pick up the slack. Problem is that the Chinese, Indians (and Japanese) like to save not spend, and that typically, private accumulated savings has to approach 300% of GDP before any semblance of "shop 'til you drop" takes hold. China is years from that level. They also lack the financial infrastructure to facilitate a consumer led

boom even if the spirit and body were willing. Credit cards and adjustable rate mortgages are not yet part of the Chinese consumer ethic. While the above is an admittedly brief summary of one of the global economy's major secular imbalances, it describes a critical variable to any forward analysis: China's wire walking needs to proceed briskly and with greater balance from internal consumption as opposed to investment – expenditures which currently exacerbate global supply.

Which brings us to the United States and its consumption excesses that have yet to be rectified. A savings rate at 2% instead of a more historical 6-8%; personal debt at near 80% of GDP as shown in the following chart; annual consumption trends that have moved from 61% to near 70% of GDP over the past four decades; the list goes on, much of which is hotly debated by economists due to the salutary effect of lower interest rates and tempered debt service. Nonetheless as economic historian Niall Ferguson reminded us, the U.S. is an empire based on consumption with the Hummer as its domestic symbol and the Humvee its international military equivalent. Guns and butter have been replaced by Humvees and Hummers as I wrote months ago – on that Ferguson and I have full agreement. The fact is that our ability and inclination to consume has given us the privilege (and presumed responsibility) to dominate global growth. That is perversely the primary reason why the global economy has recovered as well as it has these past two years – wet logs or no – but also the source of its greatest future risk as it walks the wire. An implosion in China – that is a risk for sure – but a cessation of consumption trends in the U.S. is the greater one if only because we are so dominant economically.

U.S. Household Sector Credit Market Debt as a Percentage of GDP



Source: Niall Ferguson

A U.S. consumer slowdown or even reversal could come from a number of directions although the timing is obviously uncertain. One has only to ask how we Americans have been able to get away with it for so long and you have the potential villains in sight. The kindness of strangers – a 5% annual trade deficit amounting to \$500 billion is one place to look. Either a dollar devaluation or a pullback in the purchase of U.S. Treasuries shown below could be precipitating factors since the higher interest rates would necessarily eat into consumer purchasing power.

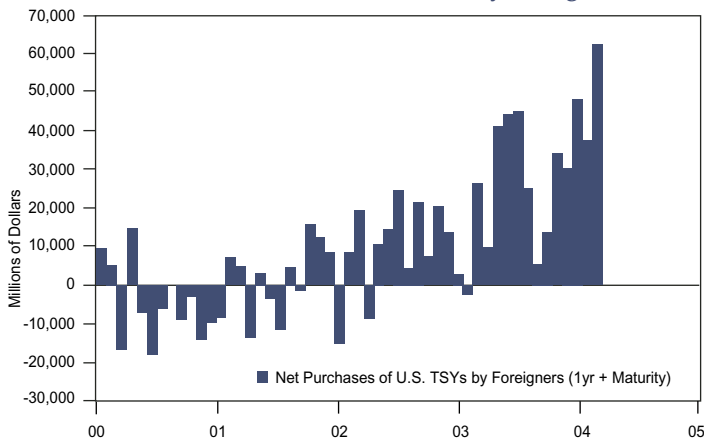
To date, Chinese and Japanese “strangers” have been kind because it suits their own agendas – employing cheap currencies to support economic growth. Geopolitical shocks in China’s neighborhood particularly related to North Korea could change that. And too, the seemingly endless pursuit of terrorists in any and every part of the globe, which is accompanied by security constraints on travel and trade, may hamper not only consumer confidence

and spending attitudes, but the continued spread of globalization itself.

More likely, however, to slow the indomitable American consumer would be internal interest rate forces in the U.S. In a financed-based economy, which the U.S. surely is, the only real way to keep an economy going is via cheap money, more and more tax cuts, and/or additional leverage. With tax cuts politically unpalatable and recent yield movements along the curve making leverage less profitable, the beginning of the end is in sight. The American consumer, Niall Ferguson hypothesized, is the least

hedged of the three major U.S. economic players (corporations and government being the others). It may take a few years for adjustable rate mortgages to adjust upward, and a few months for 0% automobile financing to completely disappear, but the trends are inexorable. To fill the consumer void will require either larger and larger government deficits or more

Net Purchases of U.S. TSY's by Foreigners



Source: PIMCO

and more business investment, neither of which is likely in light of domestic politics and China's own magnetic attraction for global entrepreneurs.

Our culminating and summarizing point about wire walking with its allusions to fire/inflation and ice/deflation is that cheap money is primarily responsible for today's economic recovery and accelerating inflation, not just in the U.S. but worldwide. When it goes away, however, we may tip the other way, especially if central banks go too far to the upside, pop too many bubbles (housing, stocks, bonds) and precipitate the liquidity trap that Greenspan has feared for years. PIMCO's Mohamed El-Erian, avoiding the circus metaphor but putting the problem in a more academic perspective, labels this situation as an "unstable equilibrium." All is well until something tips the walker to one side of the wire or the other. Higher inflation, geopolitical crisis, and financial market volatility all can tip the American consumer or the Chinese growth juggernaut to the opposite side of the wire. Inflation and deflation in this levered world coexist nearly side-by-side. Is it any wonder that in the space of the last six months we have had headline speeches promoting the dangers of deflation only to be followed by fears of accelerating inflation? "One side's ice and one is fire." We must monitor the situation closely. Our best estimate is for an "equilibrium" centered around 2% U.S. real GDP growth and similar amounts in Europe and Japan over the next 3-5 years. Wet logs redeux. What has changed this year in our 3-5 year forward economic forecast is that the conditions for instability have accelerated – more U.S. consumer leverage dependent on cheap financing; more Treasuries in foreigners' hands; more geopolitical instability; and

more risk of a slowdown/shock in Asia; all are potential sources for tipping our wire walker in one direction or another.

Investment Policy

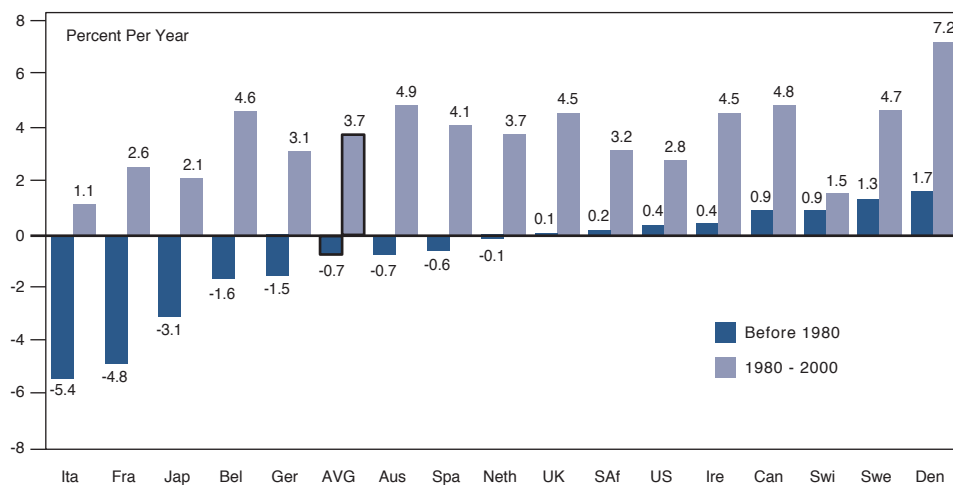
So after all this fire and ice stuff, where to put your money? The sum total is to bet on accelerating inflation (fire) due to the iron fist of government, but to watch out for global instability that could tip the other way (ice). That, I must tell you is tricky – sort of like walking the wire without a net. Because from a bond investor's standpoint, existing conditions argue for reduced durations to guard against accelerating inflation and central bank tightening, but there is a chance (20-30%) that at some point, the balance and momentum swing the other way and require greater than market durations. This may not be a secular environment, in other words, where you can successfully ride the great and long lasting waves of inflation (1965-79) and then disinflation (1980-2000) without a concern as to reversals. PIMCO made its fame and fortune partly on the basis of accurately forecasting those two primary secular trends. The future may not be so simple.

In addition to global economic and geopolitical forces cited in previous paragraphs, we will analyze most importantly the level of real short-term interest rates for clues as to what to do. Last year we asked, "How long does the Fed (and the ECB) stay low and what is a sustainable real interest rate in this new (wet log) environment?" Although it may seem obvious that the first question will be answered at least in the U.S. within a period of a few short months, the real key to the "bond alpha" generating kingdom will come with a recognition of the appropriate real interest rate that can produce a continuation of

global economic recovery for at least a few more years. As discussed last year and in recent Outlooks and Fed Focuses, we think it is a lot lower than the market does. The following chart points out that it was only during the post-1980 disinflationary period that short-term real interest rates were abnormally high on a global basis.

we prefer the front ends of the curve for now instead of long-term debt. Our focus on U.S. TIPS has been rewarded during the past 12 months and despite their revaluation by the market, they remain relatively cheap insurance for a possible inflationary surge.

Real Interest Rates Internationally Pre- and Post- 1980



Source: Triumph of the Optimists, Princeton University Press

Reflationary, government oriented periods have much lower real rates averaging – believe it or not – a negative 0.7% globally for the first 80 years of the 20th century. We believe that 1% real short rates are about all the U.S. and global economy can take given its leverage and potential for tipping into deflationary ice. If so, front end to intermediate term yields may be close to fair value given a future 3% Fed Funds level in the U.S. and a 2% rate in Euroland. Whether or not we continue to stay here will depend on inflationary trends which for now point upward. In general, therefore, we are mildly bearish on U.S. bonds, and more neutral towards global alternatives. Due to our inflationary bias and the necessity to keep short rates low,

The best secular strategy we have, however, remains our focus on non-U.S. government paper especially that in Euroland. It only makes sense, for now at least, while the globe is still successfully balanced on the wire, to purchase debt of governments that have the least inflationary bias. At the moment those bonds are issued by Germany and associated countries in Euroland. We are not significant currency investors but believe that a continuation of the recently interrupted dollar slide will persist in future years. This will add to the attraction of global debt via its inflationary implications in the U.S. and the reverse in strong currency countries. Speaking of currencies, the ultimate revaluation of the Chinese RMB, although it now

appears to be beyond 2004, will be a significant reflationary event for the non-Asian economies and add to the bearishness of U.S. bonds in particular.

Individual investors who read this *Outlook* and have stuck with this lengthy summary to this point can take advantage of our low real short rate forecast by purchasing mildly levered closed-end bond funds (especially municipal) at what are now substantial 10% or so discounts to true asset value. Purchasing a dollar for 90 cents is rarely a stupid strategy. Because of our mildly bearish stance, however, and the now apparent upward trend of most central bank short rates, investors should be aware of further price downside despite yields of 6-7% in municipals and 9-10% in many corporate closed-end bond funds.

We would also caution those that have invested in levered assets that have benefited immensely at the altar of 1% money. Although we believe short rates will stay relatively low by necessity and historical precedent, there's little doubt that U.S. and U.K. housing prices are overextended. The old saw about housing never going down in price because you don't have to sell, is vulnerable if intermediate yields rise more than their recent 100 basis points or so and adjust-

able rate mortgages ultimately "adjust." Homeowners at the margin may indeed have to sell a few years hence if monthly payments rise faster than wages and earned income.

Farewell

Well, enough I suppose of circuses and things, cabbages and kings. We at PIMCO are convinced of the current global recovery but have reservations as to its stability and longevity. How it plays out will depend on interest rates, geopolitical and U.S. consumer proclivities, as well as the continuation of the Chinese economic miracle. For now, we are mildly bond bearish – later on we could secularly reverse direction. That is the way of the wire, I suppose, dominated by the ever-present danger of tipping in one direction or another. For you our treasured clients, however, we shall endeavor to provide alpha generation of a stable and consistent nature. Elephants walk on *terra firma* and are supposedly wise and ever loyal throughout their many years. We shall be content to be labeled a circus elephant, hopefully at the front of the entourage, avoiding others' tails.

William H. Gross
Managing Director

Past performance is no guarantee of future results. All data is as of 5/18/04 unless otherwise indicated. The graphs portrayed 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 educational 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. 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. Duration is a measure of price sensitivity expressed in years. In an environment where interest rates may trend upward, rising rates will negatively impact the performance of most bond funds, and fixed income securities held by a fund are likely to decrease in value. Bond funds and individual bonds with a longer duration (a measure of the expected life of a security) tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations.

No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission. ©2004, Pacific Investment Management Company LLC. IO026-051404

P I M C O

840 Newport Center Drive
Newport Beach, CA 92660
949.720.6000