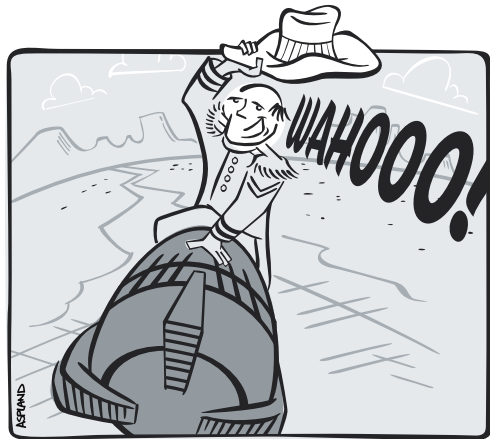




## How We Learned to Stop Worrying (so much) and Love “Da Bomb”

It’s a Dr. Strangelove world I suppose, or at least that’s PIMCO’s Secular Forum theme describing the likely global economic and investment environment over the next 3-5 years. Not that we want to start you off with the impres-



sion that we are as deranged as Peter Sellers or as far gone as Slim Pickens riding that A bomb in our cartoon caricature. It’s just after listening to esteemed speakers such as Larry Summers and Martin Barnes, and analyzing months of internal PIMCO research during our recent three-day session in Newport Beach, that like the dear Doctor, we concluded we should stop worrying so much, or if not, at least try to love “da bomb.” “Da bomb?” We use the term loosely and with the spirit of youth who describe anything that is spectacular and enviable as “da bomb.” For the purpose of this *Outlook*, “da bomb” is globalization and all of its wondrous benefits – high growth, low inflation, accelerating profits, and benign interest rates. For that matter, you can compile a short list of critical factors that have aided and abetted globalization’s surge during the past decade or so: the information technology revolution, favorable government policies including

inflation targeting and lower taxes, a shift to freer low cost markets in China and India, as well as moves towards deregulation and lower trade barriers worldwide. These have been PIMCO secular themes for years now, but somehow after

correctly analyzing the evolution of “da bomb” we never stopped worrying about it and how it might end; like Slim Pickens headed for his mushroom cloud destination 20,000 feet below, we were giddy, but subconsciously pretty darn worried. We foresaw rising global growth, but said it would be “moderate” due to a lack of aggregate demand. We spoke to a “stable disequilibrium” which referred to good times now, but maybe bad times on the horizon, and emphasized not the stability but the potential downside arising from trade deficit imbalances, U.S. debt buildup, and resultant financial flows. Those worries were enough to tilt portfolio constructions towards a more U.S. centric housing led slowdown which we hit right on the money, but they steered us away from a more global orientation where the rest of the world continued to experience 5%+ growth rates and to dominate financial market trends.

Big deal or nuance? Well the fear of disequilibrium led to underweightings in risk assets and premature positions in front-end global yield curves over the past several years, and those positions cost us some basis points. So this Secular Forum stuff is quite important after all. Water under the bridge though and this is a new Forum. We put two glasses in front of those 80 or so in attendance in PIMCO's big room (but clearly visible to the hundreds watching on screens in surrounding locations) and said: "This one's half-empty, and this one's half-full. It's up to us to choose." We didn't really vow to stop worrying – just to worry less – and to look at "da bomb" from a different perspective and ask if there was a lotta love there. Let's see what we found.

## Secular Review

① Globalization. ② Technology. ③ Freer markets/financial innovation. ④ Favorable public policy. These are "da bomb's" critical components and we could spend paragraphs expounding on the influence of each. Take it from us, we spent mucho hours of discussion with Larry Summers taking us through the intricacies of globalization and listening to the Bank Credit Analyst's Martin Barnes – well he didn't invent "da bomb" but he knows what goes into one. Let's say for now though that all of these ingredients have combined to produce the dynamic trends displayed in our four mini-charts below: accelerating global growth; disinflation; increasing returns on equity capital; and low real interest rates.

**Global GDP Growth**

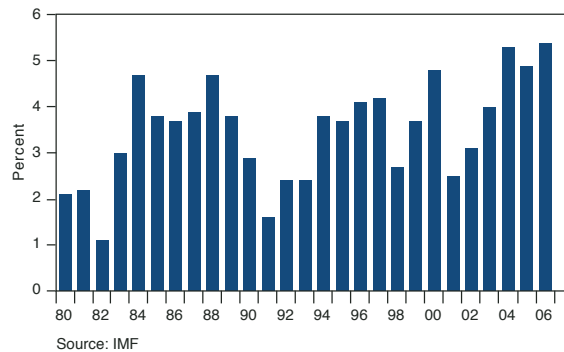


Chart 1

**Consumer Price Inflation (World Average)**

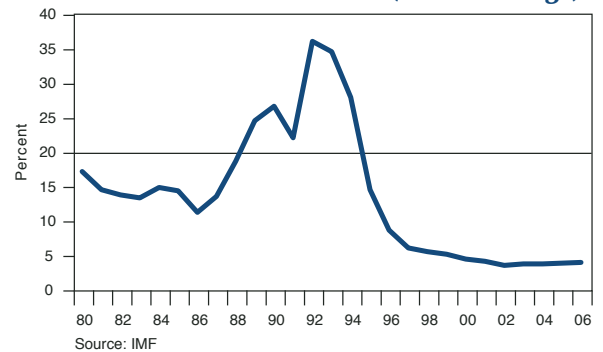


Chart 2

**Profits' Share of GDP (G7 Ex-Germany Index)**

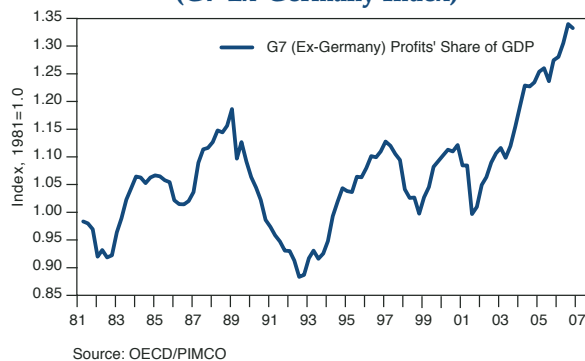


Chart 3

**"Real" 10 year Government Yield (G7 Basket Deflated by G7 CPI)**



Chart 4

And let's be clear about one important thing. As investment managers as opposed to private citizens we don't give much of a hoot about "da bomb" except as it affects those four little graphs and their trend lines that you see in front of you. Get them right and you'll have what should be described I suppose as a "quadrfecta" and a pot-load of alpha. Get them wrong and well...enjoy that ride Slim Pickens, the end is nigh! Interestingly, each of these trends has a common thread, as do the components of "da bomb": The ascendance and dominance of capital vs. labor. Add a billion or so potential workers to the global labor force, blend in a technology S curve acceleration, combine these with deregulation, lower taxes, and free trade, and you have a recipe for accelerating returns to capital and diminishing returns to labor. Higher stock prices, lower inflation, declining interest rates and importantly a rather low volatility environment for both economic growth and asset prices have resulted. It's known as the "great moderation" in economic circles, assisted not insignificantly by what has been called Bretton Woods II, a recirculation of surplus reserves into consuming nations that has promoted growth and lower interest rates – no mean feat in historical context.

### What's New?

Does this virtuous circle favoring capital at the expense of labor continue? We see nothing to stop it absent a global financial bubble popping of sorts, an accelerated decline of U.S. housing in the short run, or a U.S.-led trade policy reversal that could precipitate counter-attacks from

Asian exporters. These three are not "black swans" as they say. Asset bubbles are a near inevitable result of attractively financed leverage in search of a limited array of financial assets – and the exuberance that inevitably accompanies them. In turn, if U.S. housing declines soon morph into the consumer sector, the belief in a U.S.-centric global economy will reemerge, and a cyclical argument for slower global growth will accompany it. Anti-trade legislation may or may not become a reality. Still, odds favor a continuation of recent years' global growth rates and the favorable dynamics for most financial markets which accompany that secular 3-5 year forecast.

A bigger threat to asset markets however, comes not from slower economic growth in the short-term, but inflationary pressures towards the end of our secular timeframe. Note first of all the increasing influence of non-core food and energy prices in G-7 nations over the past few years as illustrated in Chart 5 for the United States. Since 1967, average

**U.S. Headline vs. Core Inflation  
(Annualized Difference in Avg. Monthly Rates)**



Source: Bureau of Labor Statistics/PIMCO

Chart 5

differences in headline vs. core inflation have essentially been zero, despite distinct periods of cyclical variation. Now, however, with globalization so dominant and Chinese/Asian appetites for oil, soybeans, and iron ore amongst other commodities so voracious, it's hard to envision an extended period of lower headline U.S. increases. This may bias more central banks to begin considering headline numbers in their policy decisions like Japan and the ECB do already.

There are other global threats to the disinflationary character of "da bomb." Chart 6 outlines an increasing trend of import prices from mainland China through Hong Kong and then outward. Admittedly, the appreciation of the Yuan has played a part, but that, I suppose, is the point. As the Yuan inexorably revalues, China's ability to export deflationary impulses to the rest of the world becomes questionable, especially as it itself experiences internal inflation. China may still be exporting deflation to Asia and Euroland, but it clearly is beginning to export mild inflation to Japan and the U.S. And, although China and other BRICs/developing nations will undoubt-

edly remain mercantilistic exporters for years to come, an internal orientation is developing which at the margin absorbs excess savings, increases aggregate demand, and tilts global inflation upward. Importantly, special consultant to PIMCO Alan Greenspan has pointed out that the process of transitioning hundreds of millions of workers from planned economies to a market environment may peak in the next 2-3 years in terms of its rate of growth, reducing the disinflationary impact. Additionally, common sense would acknowledge that the labor/capital tug of war which has produced noticeable inequalities between wealthy and lower class workers would begin to be rectified globally via wage and benefit gains that in turn will pressure either profit margins, consumer prices, or both. Euroland's tightening labor market may be this theory's first petri dish.

All of this will make interesting discussion points at Central Bank policy meetings for years to come. Over 20 CBs (Central Banks) are officially on the "inflation-targeting" bandwagon with the U.S. a *de facto* member since the appointment of Ben Bernanke. Yet even if the magic 2% inflation target is agreed on by nearly all G-7 policymakers, and a 3-4% target by many developing nations, once-reliable short-term rate targeting levers may not work as effectively. The abundant liquidity of today's financial marketplace may be another way of describing the ability of private agents – be they hedge funds, private equity, or simply old-fashioned banks – to create credit on their own given satisfactory reserve levels which are



Chart 6

now more than ample. Unwillingness to employ increased margin requirements by the Fed during the NASDAQ bubble, and near 0% margin downpayments accepted by mortgage bankers during the housing bubble, give evidence to the diminishing influence of CBs and the growing influence of private agents in the credit creation process. Obviously the ultimate cost of money as determined by CBs is critical in reining in unlimited credit creation, but if the price to Wall Street is far less onerous than the cost to Main Street, there may be limits as to how far CBs can raise rates and therefore control inflation. In sum, “da bomb’s” low inflationary influence will predominate but some G-7 economies may come closer to experiencing 3% inflation as opposed to 2% as we move towards the end of our secular horizon.

## Financial Markets

These portents of higher inflation and still strong global growth may seem negative for global bond markets and indeed they are, but cyclical countertrends as evidenced currently in the U.S., Japan, and elsewhere suggest caution in overreaching just yet into bearish secular territory. Additionally, astute investment managers recognize that these days, price/yield insensitive investment flows have been instrumental in “artificially” lowering global G-7 yields by as much as 50 basis points in recent years, although the dampening influence of these same flows on volatility may be a causal agent. What has been called Bretton Woods II is an economist’s label to describe the win/win game of buying surplus nations’ exports

and watching those monies come straight back into the buyers’ financial markets in a form of vendor finance – at low yields no less. Following the flows (if you can) has been key in determining G-7 yield trends both short and long-term. Government intermediate and longer curves have been pushed down, and to counter the stimulative effect, short policy rates have been set higher than might otherwise be the case. To illustrate, “10-year real rates” throughout most G-7 curves have been lower in the past few years than they have been over the prior two decades as shown in Chart 7, part of a study done by PIMCO’s Ramin Toloui.

Now, however, a growing number of investors are trying to “be like Yale or Harvard” by moving toward more diversified asset allocations, and that includes the holders of over 50% of outstanding U.S. Treasuries, Chinese and Petrodollar central authorities among them. A day after our Forum’s conclusion, for example, China eased investment restrictions in order to allow its commercial banks to buy stocks abroad. Even without a buyers’

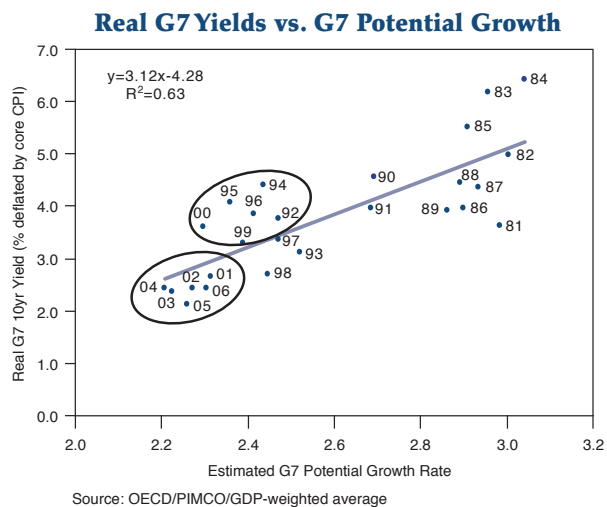


Chart 7

strike or a dramatic reversal of the U.S. current account deficit though, Treasury yields (and other widely held G-7 government issues) will lose some of their caché over the next few years and real yields may rise somewhat. Still there are limits. As our own Paul McCulley suggests, the clearing real rate of interest is not driven so much by the flows of credit, but rather the yield that is necessary to stimulate aggregate demand – that good old glass half-empty influence of recent Secular Forums. We continue to accept the global economy’s structural demand “anemia,” while acknowledging that aggregate consumption and therefore real rates are likely to be boosted as BRIC and other populations adjust to an increased level of affluence by spending more and saving somewhat less at the margin.

As an additional statement of fact, although without firm conclusion, it is striking that real global growth as shown in Chart 8 is advancing at a 5% potential rate while G-7 countries are mired at levels just above 2%. Low policy and term real rates reflective of this 2% growth are in effect financing global growth at 5% – an unprecedented spread for at least the last several decades. Investment

managers and economists are fond of speaking of the Yen carry trade – borrow near 0%, invest much higher – as being the dominant liquidity lever in today’s marketplace. Chart 8 speaks to a broader more significant carry trade which admittedly cannot be efficiently employed due to capital controls and relatively immature capital markets (China, India, etc.). Still McCulley’s demand thesis can only stand in awe at the G-7 real yield/global growth rate gap, where G-7 yields in effect stabilize their own economies but serve to encourage attractive arbitrage opportunities into investments in the BRICs and other developing economies. One wonders if there may be some move towards closure in future years, a move that in turn would increase real yields, lower global growth or both.

With the possibility of creeping inflationary tendencies, especially in weak currency countries including the U.S., combined with the potential reduction of financial flow subsidies which to this point have favored fixed income vs. equity and real commodity investments, we come to the following range forecasts for the secular timeframe from 2007 to 2011.

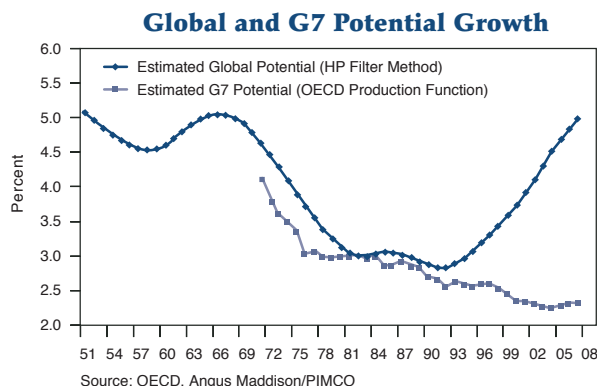


Chart 8

10-Year Note Secular Range Forecast	Region	Average Secular Inflation Forecast
4.0 – 6.5	U.S.	3.0%
3.5 – 5.5	Europe	2.0%
1.5 – 3.0	Japan	1.0%

Readers and clients again are alerted to the probability of yields closer to the lower end of our ranges during the weak cyclical environment of 2007 and

2008. The U.S. housing downturn has yet to reach bottom in our opinion and its influence on U.S. consumption and global growth yet to weigh in. Markedly different duration and curve strategies throughout the period therefore may be called for.

As a continuing theme from last year's forecast, the interest leverage throughout the global financial system will at some point pose a danger to risk-oriented markets (stocks, high yield debt, CDO structures, and housing prices). Yet our strong global growth forecast this year serves as a counterweight to perpetually glass half-empty portfolio structures. The immediate problem with a glass half-full orientation is that almost all risk spreads are already priced for the half-full or even a 7/8-full glass. What PIMCO is now attempting to identify are still appropriately priced "equity like" investments within the asset class choices available to a classic fixed income manager. If the world is going to exhibit near historic growth rates, we want to be able to participate – not only to outperform our indices but to offer attractive absolute returns as well. It will do you as clients, little good, if we outperform the unexciting asset class that G-3 bond markets represent, and yet provide returns of only 3% in doing so. What we want to be able to do is to take advantage of the high growth of emerging market economies – the BRICs and their smaller clones. That obviously can be done via emerging bond markets, yet spreads on their dollar-denominated bonds are narrow (Brazil at 75 basis points over LIBOR). The best opportunities lie

with still unexploited local currency fixed income markets (Brazil in this case at 500 basis points over LIBOR) and relatively liquid emerging market currencies which in effect allow bondholders to benefit from growth in these countries via a classically recognized yet not extensively used asset "class" – its currency. We will be in touch with you further regarding our purchase of these assets for your account.

The emphasis on emerging market currencies rather obviously suggests relative weakness of the U.S. dollar. We continue to believe that U.S. growth will descend towards the lower quartile of countries within a broad global composite. Such U.S. growth, despite relatively favorable demographic labor force trends spiked by immigration, will suffer due to reduced U.S. consumption and the need for higher savings. Even in the face of resistance by Chinese authorities vis-à-vis the Yuan and the Japanese via artificially low interest rates, this lower growth speaks to a weaker dollar and lower relative asset price appreciation in comparison to the rest of the world. PIMCO portfolios will therefore likely feature increasing international diversification in foreign currency terms.

We recommend as well that clients and other readers continue to diversify their asset mix with a growing percentage of commodities. In addition, Chart 8's gap between G-7 financing rates and global economic growth indicates an asset bias towards owners not lenders. PIMCO, while continuing to be recognized as the authority on bonds will hopefully be able

to assimilate equity-type returns into new products as well as many standard conventional portfolios.

## Conclusions

We started out by suggesting the potential for a Dr. Strangelove world, and our conclusions suggest we may get it. “Da bomb” in the form of sustainable global growth with perhaps an early cyclical slowdown appears to be the likeliest outcome. Those who “own” this growth as opposed to those who lend to it will benefit. We will attempt to position ourselves to exploit this secular change in emerging economies, mindful of our roots as well as the inherent risks in the world of levered finance that is flocking to be like

Harvard or Yale during a period of rising valuations. That suggests increasing scrutiny of not only economic growth, but the prices of assets that discount such growth. Hopefully at the end of our secular timeframe in 2012 we will be shouting “Wahoo!” like our boy Slim Pickens. It promises to be quite a ride. And as always, we thank you, our clients, for your trust and the opportunity to express all of the views expressed in this *Outlook*. If we worry about one thing it’s your satisfaction with our performance. Let it always be thus.

William H. Gross  
Managing Director

### Secular Forum Conclusions For the Next 3-5 Years

- 1 Global growth strong at 5% subject to an early U.S. cyclical slowdown.
- 2 Global inflation pushes slightly higher due to commodities and assimilation of internal growth dynamics in developing economies.
- 3 Interest rates move higher a few years hence due to inflation and the bond “subsidy” giving way to asset diversification on the part of surplus reserve nations. A weak cyclical U.S. economy argues against bearishness near term.
- 4 Dollar-based assets and the dollar itself will underperform global alternatives.
- 5 Capital will continue to dominate labor. Owners, as opposed to lenders will benefit.

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