

## The Strange Tale of the Bare-Bottomed King

They say never sell America short and with good reason. Any country whose equity market has been able to crank out 6.8% real returns annually over the past century stands as a formidable obstacle for any speculator willing to bet the “don’t come” line. The odds of winning a long-term wager laid against the U.S. “house” have been



about as bad as heading out to the track and betting on your favorite color of jockey silks. Even when the bear gets his facts right, the timing and the wait often spell his doom; the “house” has more chips, especially a house with reserve currency status like the U.S., so a wager must be done prudently in order to conserve capital for that prospective rainy day.

Our recent PIMCO Secular Forum, held over a 3-day period in mid-May, discussed this cautionary and historical framework within the context of a U.S./ global economy that clearly had begun to resemble a casino, but nonetheless appeared to have ample chips or reserves to keep the game going for awhile. Speakers such as Michael Dooley,

conceptualizer of the current Bretton Woods II arrangement, and Jonathan Wilmot of CSFB, presented their bullish and in some cases bearish arguments for economic growth and investment returns over the next 3-5 years. Over 100 PIMCO professionals actively participated in the discussions and

decision-making, which by its heritage has a long-term secular orientation. In the end, while the gambling metaphor and betting against the house advice was more than apropos, we chose instead to weave our tale around the story of the Emperor who had no clothes and the solitary boy who in his innocence cried out that this sovereign was indeed – naked. Not wanting to sell America short just yet however, and being mindful of our country’s dynamic past and the lessons that its history inevitably has taught wayward doubters, we decided to modify the parable just a tad. We agreed that the U.S. was indeed King of the World and was indeed outfitted in a grand set of clothes. Biggest economy, most powerful military, best universities, highly productive, freest capital markets, bearer

of the world's reserve currency status – these are all characteristics that describe our current King, and any little boy or bear who shouts that they can't see them is close to blind. So our monarch has some spiffy threads indeed. Still, after analyzing not only the U.S. in 2005, but the global kingdom that it rules, we had legitimate concerns as to how well those threads were put together. They look good, but can they hang tight without shredding during a storm, or will they come undone, leaving our ruler bare-bottomed in the wind? The answer, we decided, was dependent on the quality of the cloth and its stitchery – how well they were put together – and of course, the probability of a storm epitomized in our cartoon by the terrier of Coppertone fame. But lest we give too much away in this reality–show fairytale let us recap the past and begin as they say at the beginning.

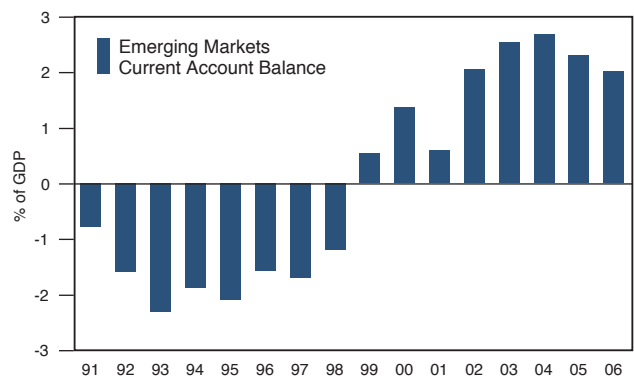
## Secular Review and Current Update

One day sometime in the early 21<sup>st</sup> century, there was a global economy that was growing at what appeared to be a decent enough rate but which was suffering from a strange malady – something economists describe as a lack of “aggregate demand” – in essence an inability to make use of available global capacity to produce. Now that was a condition that most citizens could hardly comprehend because mankind's desires/demands appear to forever be insatiable. We always want more of everything so how could there ever be a lack of “aggregate demand” in this magic kingdom? The historical textbook example

of this malady probably first appeared during the depression of the 1930s when what Keynes labeled as capitalism's “animal spirits” were so dampened that corporations and consumers sat out the dance, preferring to hide their money in a mattress instead of risking it in a transaction during a deflationary spiral. In their place, government became the buyer of last resort. The world's most recent example has unfolded in Japan over the past decade, but scores of other instances now abound centering around either 1) mercantilistic or 2) demographic secular influences. The mercantilistic draining of global demand has its most recent origins in the Asian crisis of nearly a decade past when South Korea, Malaysia, and others left themselves exposed to the seemingly whimsical liquidity injections – then withdrawals – of global bankers and investors. Whispered vows of “never again” placed an increasing emphasis on exports/production as opposed to imports/consumption and the result was massive increases in Asian and selected emerging country reserves as the U.S. current account deficit helped build the war chests shown in Chart I.

Chart I

### EM Surpluses Add to Consumption Drag

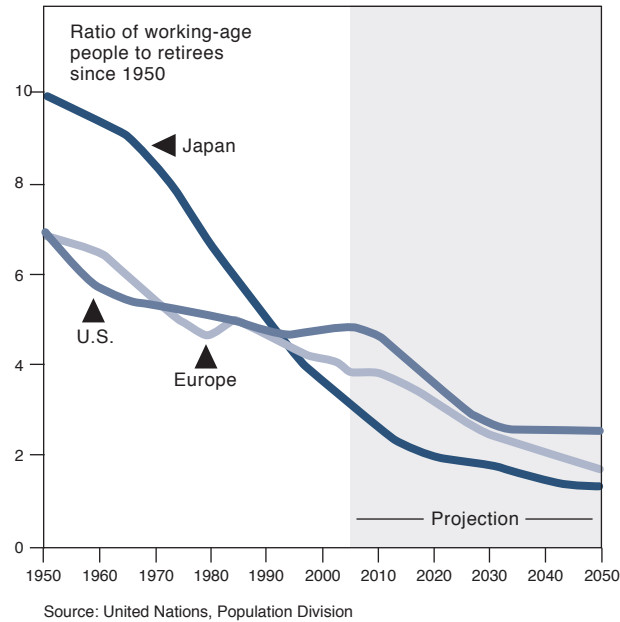


Source: Goldman Sachs

“If you don’t have enough reserves it can cost you a lot. We learned that (in the late 90s),” ex-Korean official Hong-choo Hyun warned recently. Asia’s mattress in the past few years, then, has taken the form of massive recycling of reserve surpluses into U.S. Treasuries instead of reinvestment in infrastructure or government sponsored business ventures. To make this arrangement possible, a fixed currency in China and “dirty floating” currencies in the bulk of Asia have mirrored an image reminiscent of the Bretton Woods era of reserve management during which the U.S. dollar was fixed to gold and the remaining currencies were fixed to the dollar. Our new arrangement is being labeled Bretton Woods II even though the dollar no longer has any such anchor and currencies such as the Euro are free to float. China itself is expected to institute a freely floating currency within the context of existing WTO plans during the next 3-5 years, but for now, BWII and its currency fix is standard operating procedure.

Supporters of this process such as Forum speaker Dooley, argue that its informal yet semi-regulated structure is helping to generate sufficient global demand for goods and services by flowing money from those countries that want to produce (Asia) to countries that still want to spend (the U.S.), and they have a point. Yet to focus on currently attractive global growth rates under the umbrella of Bretton Woods II misses the broader and overarching point. The global economy needs more consumers, but because of prior financial crises and advancing demographic

Chart II  
Growing Older



influences that focus on savings for retirement, shown in Chart II, the primary willing spenders reside in the U.S.

Newly prosperous emerging market countries are the world’s natural deficit countries – instead they are building surplus reserves. Together this combination of American shoppers and Asian/emerging market/European savers are exchanging dollars, and goods and services in what for now appears to be an OK arrangement for both parties. But because it is so consumption one-sided, there are risks – increasing risks – that this apparent equilibrium is rather unstable and may at some point tip over. Unless Asia and Europe can join the consumption party, there may come a time when the U.S. Viagra wears off. Because of Bretton Woods II, the recycling of reserves into U.S. Treasuries has allowed Americans to finance their imports at exceedingly

attractive interest rates. Yields on U.S. Treasuries and corporates may be as much as 100 basis points below prior equilibrium levels, so if the U.S. is King, then we undoubtedly have purchased for ourselves a fine set of clothes on cheap credit. The new threads, however, have been secured on the back of rapidly increasing debt, resulting in a 6% of GDP balance of trade deficit, and that debt has been extended to consumers only because of asset appreciation in the financial and housing markets. Can this King continue to reign over a seemingly prosperous yet imbalanced global and U.S. economy?

We advised in prior pages that the King's clothes and their ability to cling to his bod were dependent on two things – the quality of the stitchery and the potential for a storm. Let's put ourselves first of all in the role of royal seamstress to get a behind-the-scenes look at how these clothes have been put together. We acknowledge once more that the finest cloth has been purchased due to productivity advances, leading technologies, superb higher education, free-flowing capital markets, and a military dominance that allows the U.S. to exert its will in supranational agencies such as the U.N., World Bank, IMF, and the WTO. But in recent years, America's growth has been stitched together more from the iron fist of government policies than the invisible hand of a dynamic free enterprise economy. (In a world deficient in aggregate demand, the case for free markets and the invisible hand grows weaker as PIMCO's Paul McCulley has pointed out.) Its budget surpluses of the late Clinton years are a distant memory

due to tax cuts and Iraq-related defense expenditures. Without them however, and the resultant deficits, our recovery from the stock market "bubble popping" of 2001 might never have occurred. In turn, reflationary monetary policies of global central banks, especially our Federal Reserve, have fostered a low nominal and much lower still real interest rate environment that has remarkably failed to stimulate normal domestic investment as in prior business cycles. Instead it has led to higher levels of U.S. consumption due to housing appreciation/equitization which have provided the ability to buy goods with money that can only be described as near "costless." Without this government intervention, which in some ways is reminiscent of the 1930s depression – differing for the time being primarily in its earlier and more efficient implementation – the U.S. and global economy might be sinking instead of floating.

## What's New

**But there are limits, both fiscal and monetary, and the monetary limit – what we will describe on the next few pages as the "Pump," as well as our recognition of the still developing Bretton Woods II policy arrangement – stand as PIMCO's primary 2005 additions to our ongoing secular outlook. While Bretton Woods II is odds-on in PIMCO's book to be with us during the bulk of our 3-5 year secular timeframe, and therefore continue the 100 basis point interest rate subsidy to our financial markets, there undoubtedly are risks that must be monitored. It isn't prudent for U.S. citizens to continue to expect to consume 6% more than they produce, nor is it rational for investors to**

expect foreign central banks – primarily the Chinese and Japanese – to invest that 6% surplus and other direct investment monies into the U.S. Treasury market forever. At some point it comes undone, either through a massive revaluation and dollar decline, a Treasury buyer’s boycott, or a whimpering U.S. consumer beaten down by the cost and/or amount of their burgeoning leverage – much of which is housing related. Geopolitical risks abound as well with North Korea, Taiwan, and Iran serving as potential flash points. Since the Bretton Woods II arrangement currently seems to satisfy giver and taker, consumer and maker, it should survive for a few years. Cross those fingers, though.

Because that conclusion nearly mandates a continuation of our artificially low U.S. and global interest rates fostered at the expense of the yield insensitive Chinese and Japanese Bretton Woods II (BWII) “cartel,” it might seem that all we as bond investors have to do is to head for the bar to get a tall cool one. But that would neglect the potentially reflationary impact of this artificially low yield environment. Surely, near 0% real short-term rates here and abroad have got to stimulate an inflationary resurgence. Au contraire. China has opted into BWII for one reason only – to employ hundreds of millions of unemployed workers in its interior. And it is those same workers, requiring only 5-10 cents per U.S. wage dollar that have kept inflation competitively low nearly everywhere in the global economy. What inflation we do have – 3% in the U.S., 2% in Euroland, 0% in Japan – is due to asset inflation – higher commodity prices, higher housing prices, and higher stock

prices – creating artificial wealth and immediate purchasing power through what we described at our Secular Forum as the “Pump.” In some secular stretches, real, not artificial wealth is generated by productivity surges and the advancement of new technologies. The 1990s was such an example, but during the past five years wealth has come more from finance-based miracles than those based on productivity.

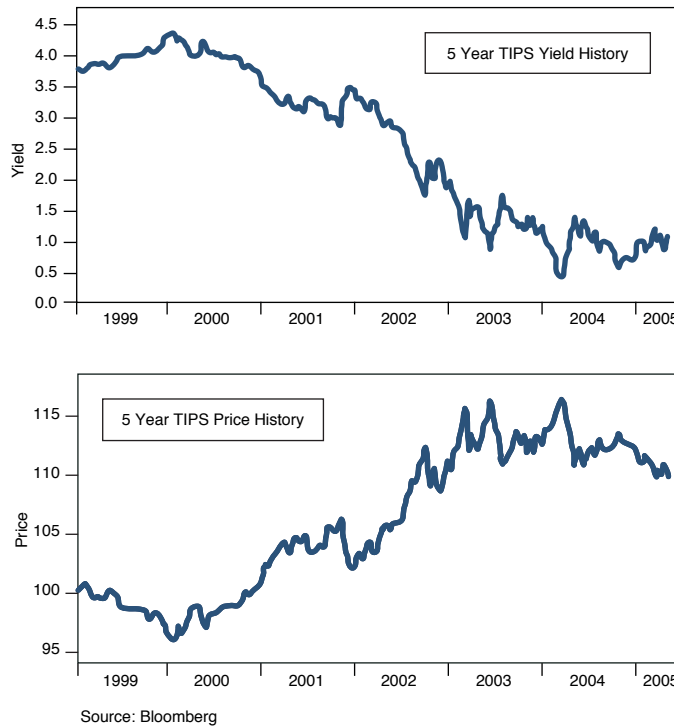
Nearly everyone knows that oil prices, housing prices, and even stock prices are up in the past few years and in some cases spectacularly. Not everyone knows why. Enter the “Pump.” The pump in its purest sense – sans the risk premium, and the P/E, P/Rents multiple changes of stock and home prices – can best be explained via the price action of a good old inflation protected Treasury, a 5-year maturity TIPS shown in both yield and price terms in Chart III.

This asset has been “Pumped” over the past 4 years to the tune of 14% price appreciation by the low interest rate policy of Alan Greenspan. Its 4% real yield has been lowered to 1% real yield with a resultant 14% price pop. That increase is reflective of the wealth creation pump for more well known asset classes – our homes, our stocks, our corporate bonds with their CDO structures and so on, except in these cases, the asset pop has been more than 14% because they are risk assets and in many cases levered ones.

Now this concept of the “Asset Pump” (which in combination with fiscal deficit spending and associated tax cuts has been the primary U.S. induced policy to keep

Chart III

The Pump



consumption up and the recovery going) is important to understand because it gives us a strong hint about our economic and investment future and allows us to describe our King's seamstress as having done a rather poor job of sewing. That seems evident because her creations have been put together not based on savings and domestic investment but on finance-based consumption fed from asset appreciation based on the Pump.

Future finance-based consumption, however, is limited by our ability to keep pumping lower and lower yields, which in the past have led to higher and higher TIPS, home, stock, and associated asset prices. Let me do the TIPS math for you and then you can draw the implications

for other asset classes. The 14% 5-year TIPS capital gain over the past few years that Alan Greenspan has been able to manufacture probably can only go up by 5 more points, because a 0% real yield for a 5-year maturity TIPS serves as a practical limit that investors will tolerate during deflationary, and most low inflationary environments. A 5-year TIPS moving lower in yield from 1% to 0% goes up 5 points. Even if the Fed continues to "Pump," then, we are  $\frac{3}{4}$  of the way complete in terms of the Fed's ability to continue to stimulate asset prices, because its 21<sup>st</sup> century journey started at 4%, we are now at 1%, and 0% is the practical limit. That doesn't mean that the housing "bubble" can't keep going because it likely will if the Fed "Pumps" real yields closer to 0%. But there are limits, and we are heading down the home stretch of this U.S. race towards prosperity based on asset price appreciation.

**Our point on the "Pump" then, is to suggest that in combination with a globalized free trade-based economy exhibiting a surfeit of cheap Asian labor, it will be difficult to generate U.S. inflation higher than our current 3% even if interest rates fall further. If 3% inflation is all we can get from the past 5-years' asset inflation, it's hard to believe that we get more from what's left. The potential to reflate via interest rates is nearly over.**

We draw the same conclusion for Euroland and Japan. Japan, of course, is the primary example of how 0% nominal yields can fail to generate any inflation whatsoever, is it not? Continued disinflation not reflation, then, will rule our fragile future kingdom, with the potential for 1-2% CPI prints in most years between 2006 and 2010 throughout much of the global economy. Readers may remember our past few years' Secular Forum descriptions of the tug-of-war between disinflation and reflationary forces. **We have proclaimed a winner based on our observation of massive fiscal and monetary global stimulation described above, the limited inflationary response, and the lack of further ammunition. Long live our disinflationary King.**

### **Investment Implications**

**The risk to bond markets going forward, therefore, will not be from having too much high quality duration, but too little. The demand for Treasuries should continue at high levels from foreign central banks due to the continuation of Bretton Woods II and from private global bond investors who will sense no threat from accelerating inflation over our secular 3-5 year timeframe.** In addition, as our Secular Forum speaker Olivia Mitchell described, private and public sector pension fund changes are underway which will likely mandate increased allocations to long-term bonds in order to accommodate many nations' demographic surge towards old age and retirement. The change is even further advanced in Euroland based on UK and Dutch pension accounting modifications. **If we had to forecast (and we do), we believe a range of 3 - 4½% for**

**10-year nominal Treasuries will prevail during most of our secular timeframe and that yields on Euroland bonds will be slightly lower due to their structural unemployment problems, disinflationary incorporation of new Central and Eastern European countries into their existing family of nations, and more growth-inhibiting demographics.** This bullish scenario is not without its risks, be they geopolitical, trade, oil, or internal budget popping related in the U.S. or Euroland. In addition, anything that threatens BWII or resembles a "helicopter money" monetary response described by Ben Bernanke could ultimately be bond market destructive.

Furthermore, the inherent leverage throughout the global financial system will pose a danger to risk-oriented markets (stocks, high yield debt, CDO structures, real estate) as owners gradually realize their returns can no longer be pumped anywhere near double-digit expectations. Whether this can be accomplished gradually as central bankers maintain or happen quickly as others believe is an important question, and points to the potential storm referred to in previous pages. We would suggest that although financial innovation and derivative products allow for diversification and a spreading of risk across more market players, the increased liquidity of our modern day system has also allowed for increased leverage, quicker exits, and therefore more systemic, system-wide risk. If institutional and retail investors in levered products become increasingly disenchanted with quarterly/annual returns, an unwind of levered structures could take place even in the face of

continued economic growth, much like we've seen in recent weeks.

Well our reality-based fairytale must now come to a close. The one reality we are sure of is that we at PIMCO are most fortunate to be entrusted with the management of your assets. The responsibility, while heavy, is the reason we are in business. Thank you. As to happy endings in the global economy and financial markets? Well some assets – high quality bonds, and certain commodities in limited supply among them – may continue to do well; other risk-oriented holdings can be pumped only a little bit further. And then? Well, given appropriate steps from government policymakers that attempt to rebalance our decidedly imbalanced global economy, we can still continue to prosper,

but as with most fairytales, the wicked witch lurks. For now we at PIMCO will be content to acknowledge our reigning King's clothes, the poor quality of the stitchery, and the partial exposure of his bare-bottom displayed on our front cover. Stay tuned in future years. This may yet turn into a reality show that resembles not the Coppertone Girl but Uncle Sam with a crown on his head and not much else to show for his / our years of profligate consumption based upon Bretton Woods II and the leveraging of near costless finance.

William H. Gross  
Managing Director

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