

Tipping Over

*Things are never what they seem
Skim milk masquerades as cream*

– Lewis Carroll
Through the Looking Glass

It's an uncertain world these days, with the polls split down the middle and Heisenberg long ago having declared that something can be here or not here at the same instant. And for those of you who have no idea what I've just said I can only offer you congratulations on your blissful certitude. Death and taxes may head up both of our lists, but your list is probably much longer and therefore the midnight hours much shorter. But it being near November 2nd and all, I will offer up one sure-fire prediction that will scare the hell out of all you Republicans and maybe a few Democrats as well. If George Bush is re-elected, you can be sure that Hillary is next. That's enough to get you to pull the lever for Ralph Nader I'll bet.

Despite candidates' insistence that this is the most important election of our lifetime, I suspect that the ones in 1980 and 2000 were more important, and the latter was decided by 500 votes in Florida or the U.S. Supreme Court depending on your political persuasion. Four years later and much deeper in debt, there's little either candidate can do to stop the near inevitable hegemonic (not hedonic!) decay. It's really quite simple you know. Asia has hollowed out our manufacturing base and is now making inroads into services. Job growth is and will continue to be hard to come by. To compensate we

temporarily turned ourselves into a finance-based economy, dependent on paper profits and capital gains that in turn were driven by the march to historically low interest rates. That journey ended sometime over the last year or so – some marking their hegemonic calendar at June 13, 2003, the 3.13% low of the 10-year Treasury, others signaling the beginning of the end on June 29, 2004, the point of the Fed's first cyclical hike in short-term rates. Whatever, whenever. If the driver of profits and job growth is the price of money as opposed to domestic investment, it should come as no surprise that when the price goes up, the good times fade away. Either Bush or Kerry – Hillary as well – will have to contend with this near inevitability. Looks like James Carville was right after all.

I suppose I sound pretty certain about this, a little anomalous you might say after having led off with reference to Heisenberg's "Uncertainty" principle. My highly probabilistic attitude stems from the commonsensical observation that we can't really educate or innovate our way out of this. 250 million Americans sitting around thinking up ways for the rest of the world to support us is not my idea of a real world outcome. At some point we have to begin to give something back besides Krispy

Kremes, Starbucks franchises, and Treasury bonds. Unfortunately that will require some other kind of work than checking for messages on our BlackBerrys or managing investment portfolios for that matter. And it will require saving as opposed to consuming – something that several generations of Americans know nothing about.

But enough of the economics of despair, I write to bring you an investment idea of hope. Recently, I presented a PIMCO client seminar with a handwritten memo entitled “The Things I’m Most Certain Of.” That’s what investing is all about of course: determining what it is you can be most confident of and then placing your bets in a measured proportion that reflects that confidence. To think that any idea has anything more than a 2:1 outcome given the near transparency of information and its immediate influence on prices would be somewhat delusional I suspect, but there is always something that we are most certain of. The trick is to avoid the slam-dunk exuberance, which could spell disaster for a portfolio. The one investment certainty is that we are all frequently wrong.

But I wax philosophical and not financial. My/our most certain idea, as expressed in previous *Outlooks*, is that **real interest rates in the United States will have to be kept low, that the old Taylor rule is out. Too much debt in a finance-based economy precludes raising interest rates like we have in the past and while that keeps the patient/economy breathing; it leads to asset bubbles, potential inflation, and a declining currency over time.** How should an

investor attempt to exploit this condition? Buy the assets that are being bubbled, invest in bonds that are protected against inflation (TIPS, German bonds with less inflation risk) and short the dollar – all very carefully, by the way, as described in the above paragraphs. Some asset and currency prices are nitroglycerine. One false move can ruin more than your day.

While currencies are not my specialties, bonds are, and I have a few more specific thoughts on TIPS and the yield curve in particular, especially in reference to the thing I’m most certain of – low short rates. The low rates I speak to are really low real short-term rates. If inflation continues upwards it would be logical for the Fed to raise nominal short rates just enough to contain prices, but not kill the economy. We have suggested $\frac{1}{2}\%$ real as a future Fed target, but no one really knows – we will all just have to find out. With so much debt in our economy as seen in Chart I, a subjective analysis would caution against raising real rates too high, and so far the Fed seems to agree. Fed governor Janet Yellen in an October 21st speech made a distinction between the “long-run equilibrium

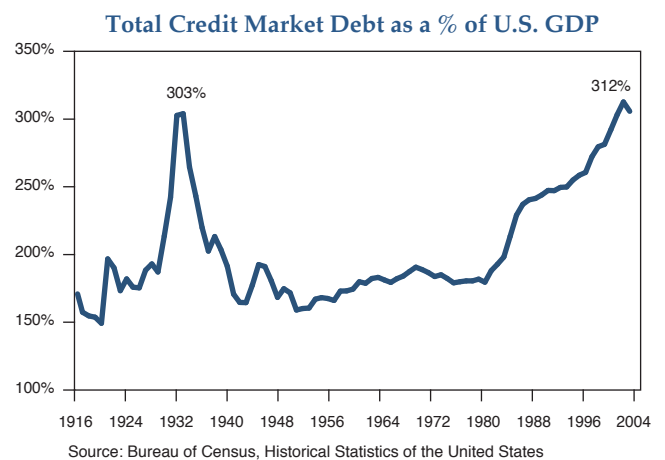


Chart I

real rate” (Taylor rule) and the “intermediate equilibrium real rate,” stating that factors such as oil prices, investment spending, job growth and consumption – in other words the economy – must improve before we can safely raise real rates back to recent decade norms. PIMCO believes that will be a long time coming.

But if the Fed and the economy face a low real short-term interest rate future, TIPS investors can take advantage. Since TIPS holders are protected 1 for 1 against increases in the CPI, the only thing they have to worry about is changes in real interest rates, the fundamental driver of TIPS prices. And if real short rates are capped (although the level and longevity of the cap are uncertain) then the risk of a decline in TIPS prices is reduced – and the potential for an increase may be enhanced. Now take this hypothesis to its extreme conclusion, if only to play a mind game. If real short rates were capped for a period of some years at say ½% and the Fed told the market that this was so, then all TIPS with maturities inside that timeframe should trade at close to the same yield, ½%. There are theoretical reasons why these maturities may not trade exactly the same, but ride along with me for a second in my simplicity. If they traded at the same yield and that yield was ½% then there are a lot of underpriced and overyielded TIPS out there. Take a look at Chart II.

Any yield above the .5% horizontal line on this recent TIPS yield curve would represent an opportunity as long as the maturity fell within the timeframe of the Fed’s theoretical real interest rate cap. Granted, maturities as long as 2032 are a little

beyond the scope of reasonable analysis but 2009-2014 may not be. It is logical to assume that a debt-laden economy such as the U.S. with financed-based as opposed to investment/work-based proclivities would take at least a decade to either inflate away its problems via low real rates or change its work ethic, forced by a declining dollar.

Now, for you purists, let’s stop playing simple mind games, which unrealistically assume the Fed would announce a cap on real interest rates. Let’s just assume that over a period of months/years that the market figures out that’s what they’re doing. We’d get a modified outcome, a flattening of the TIPS yield curve that favored 2009+ maturities at the expense of shorter TIPS and indeed all nominal Treasury, corporate and mortgage-backed bonds. Now to get technical here, I have no doubt that certain portions of nominal yield curves would benefit as well, but because their value depends on both the real interest rate component as well as inflationary expectations, the benefit would be diluted, especially if this real interest rate cap were seen as inflationary – which it probably is.

Markets and life are never as simple as we pretend. Skim milk frequently masquerades

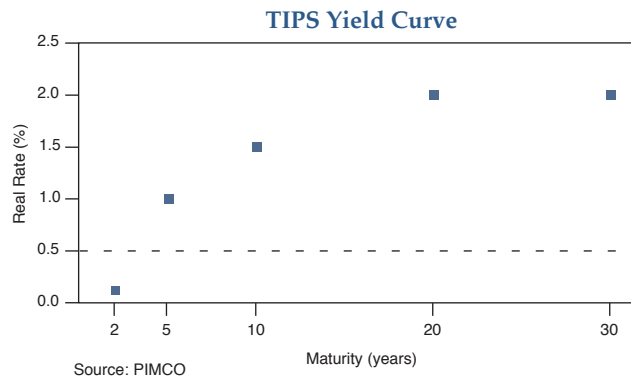


Chart II

as cream. But the thing I/PIMCO are most certain of in this uncertain environment is that real short rates must stay low – perhaps as low as ½%. The debt-laden finance-based U.S. economy is simply too fragile to tolerate what many consider to be more normal, Taylor-based real yields of 2% or so. If so, assets that can lever off of an attractive low real rate and securities that are priced by real rates themselves (TIPS) offer opportunities as the marketplace adjusts to these new realities. Lay investors may be befuddled by the technical implications outlined above and simply content themselves with owning a TIPS fund – again with recognition of the inherent risks of anyone or any firm being right all of the time. It cannot be done. The funds they own, however, should

be managed by professional investors willing to prioritize their own most certain ideas and to draw investment conclusions from them. Aside from the near inevitability of Bush yielding to if not Kerry then Hillary in future months and years, low real short rates are my current best bet. And one of PIMCO's new strategic bets based on this hypothesis is to own intermediate TIPS with real yields higher than ½%. We'll be voting with our dollars. Make sure you vote too on November 2nd.

William H. Gross
Managing Director

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