



IMAGINE

A human being is part of a whole, called by us the "Universe," a part limited in time and space. He experiences himself, his thoughts and feelings, as something separated from the rest – a kind of optical delusion of his consciousness. This delusion is a kind of prison for us, restricting us to our personal desires and to affection for a few persons nearest us. Our task must be to free ourselves from this prison by widening our circles of compassion to embrace all living creatures and the whole of nature in its beauty.

Albert Einstein

I am he as you are he as you are me and we are all together...

I am the walrus, goo goo g'joob.

John Lennon

"I am becoming more Eastern in my thinking," I told a close friend during a recent private moment. He looked at me as if I had some explaining to do and that I better do it fast. If there were any gerbils associated with this story, his face seemed to say, then PIMCO had better be hiring an additional PR agent and definitely not Richard Gere's. Not to worry, I proceeded, this isn't a religious conversion or anything – more of a way at looking at life and my bit part in it, and I like some of the things that Eastern philosophies have to say. Not that you have to be Asian to say them. Albert Einstein, cited above, was anything but, and John Lennon was...well if not the walrus then...John Lennon. What they wrote though that appeals to me and resembles the philosophies of Confucius, Buddha, and Lao Tzu among others is their emphasis on egolessness – their attempt to cancel the screeching and often destructive noise of the "I." The ego and its

need for recognition has always been an important part of my existence. "I'm not sure," my wife Sue remarked the other day, "where you and our kids got that 'fame' gene. The roar of the crowd only lasts for a few seconds," she continued, "and then you've got to go back to living your everyday life. I get a bigger high just by buying a pair of shoes, and it lasts for months!" She has a point, some really nice shoes, and a wonderful perspective on other people and her place among them. My point though is not to eliminate the "I's" – there have already been eight in this *Outlook's* dialogue so far. There's no getting around the fact that we as individuals are part of this cosmos – if only for a short time. But it would be constructive, as Einstein suggested to extend the "I" beyond an inner circle, to acknowledge in our belief systems as well as our everyday behavior that we share this planet with other people and indeed all living things. When John

Lennon sang, "I am the walrus," he meant, I think, that he shared the wonderful gift of life with them; that we were all part of the same play on the same giant stage. Oh how we all could benefit from that understanding. A little less "I" and a little more "we." Goo goo g'joob.

Now let's turn to money and to how to either make more of it, or at least keep what we have; an "I" thing perhaps, but by extension of this *Outlook* to clients and its readership, a "we" thing as well. My gift to you, I suppose – for what it's worth. My outlined notes read as follows:

- 1) **Invest in reflatables.**
- 2) **Invest in securities that borrow at 1% instead of lend at it.**

That's about as succinct as I can get in summing up what I think lies ahead over the next 12 months and beyond. Faced with the apparent necessity to maintain U.S. citizen's standard of living in the face of a declining currency and the loss of millions of jobs to Asian/Indian competition, our government is leading the worldwide charge to reflate. Negative short-term rates, \$500 billion deficits, sharply lower tax rates, costly new prescription drug benefits, and even a Kennedyesque pledge to beat the Chinese to the moon for whatever that means, are all geared to get our economy moving again. "Damn inflation, full speed ahead," Greenspan has said both in action and in word. I think an investor should believe him and invest accordingly. Not that inflation's spectre will immediately haunt us. There's too much spare capacity and unemployment to produce much beyond the standard 2-3% forecast in the next

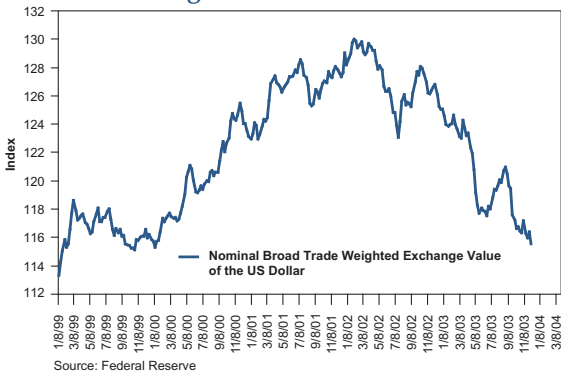
year or so. But markets anticipate, often incorrectly, yet still they anticipate. \$800 gold in 1981 and NASDAQ 5,000 three years ago are graphic examples of investors extending trends into the hereafter. This current reflationary reversal, however, remains in its infancy – in fact there are justifiable reasons to doubt its longevity – globalization, productivity, and such. If it climbs in future years, it will climb that wall of worry that stocks are often accustomed to. But 1% short rates, a 10%+ annual decline in the dollar, hundreds of billions of guns and butter, and Hummer and Humvee deficits are powerful medicine. Investors need only IMAGINE the inflationary impact of such events a few years hence to place the majority of their chips on the inflationary as opposed to the deflationary side of the table.

How to do that? Well, as any astute investment advisor would point out, risk preferences, time horizons, and financial balance sheets are critical qualifiers. Each investor must inject his/her own financial profile into the decision making process. Still, investors may benefit from the following asset categories ranked in this case according to my own personal preference:

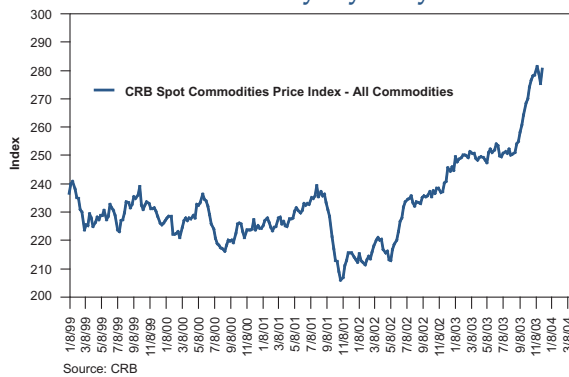
- 1) Commodities and tangible assets
- 2) Foreign currencies
- 3) Real estate
- 4) TIPS
- 5) Global bonds and equities denominated in non-dollar currencies

Of the items on this list, perhaps only #5 needs any explanation. Global bonds seem an odd choice in a reflationary environment except for the proviso that a

Imagine there's inflation...



... it's easy if you try



global bond fund, for instance, when denominated in non-dollar currencies offers several advantages when compared to its U.S. counterpart. First of all, the foreign currency hedge should dominate annual returns even if yields trend higher; and secondly, non-U.S. bond markets (chiefly European, Canadian, and Australian fixed income alternatives) present an investor with higher real interest rates and therefore an opportunity to earn something over and above inflation in the long term. U.S. bonds, aside from TIPS, currently offer less in the way of real interest rates. Global equities present an investor with several advantages that U.S. stocks do not. Most of them begin with cheaper valuations than in the U.S. and certainly higher yields. The UK's FTSE for example yields 3.7% compared to the SandP 500's 1.6%. In addition, emerging market equities sell at P/E's far below those in the U.S. Dow 5,000 may be years away, but current valuations in the U.S. still argue for caution despite the ability of most companies to compensate for inflation via price increases over the long term.

My second point concerning the necessity to borrow at 1% instead of invest at it needs perhaps a little more explana-

tion. As previous *Outlooks* have pointed out, negative real interest rates – 1% Fed Funds currently – present an onerous obstacle for fixed income investors. Not only do the negative real yields ultimately generate future inflation and therefore bond price declines, but also those seeking to take refuge in defensive short-term cash earn negative real rates of return. Damned if you hold bonds, damned if you don't. The way around this is to borrow at these negative short-term rates not lend at them. Now as last month's *Outlook* pointed out, PIMCO doesn't intend to turn itself into a giant hedge fund, but several of the structural strategies we have been utilizing for decades are only enhanced by negative real short rates and a sharply positive yield curve. Financial futures and forward mortgage rolls effectively borrow at 1% or less and free up cash to invest at higher yields at the 6-12 month portion of the yield curve. While individual investors cannot easily replicate such tactics, there are several alternatives available to them that are reasonably conservative and that should add dollars to the bottom line over the long term. The first idea is to invest in closed-end bond or equity funds that borrow at 1% and employ mild leverage to increase total portfolio yields and returns.

Theoretically the non-institutional investor can employ a margin account to do much the same thing but the borrowing rates are nowhere close to the 1% yields available to bond and equity funds. In addition, for the municipal bond investor, borrowing via a margin account to buy tax-free securities is not permitted. Closed-end municipal bond funds, however, can legally do so. A 50% levered fund via such alchemy can turn 4-5% long-term municipal bond yields into a 6½-7% yielding portfolio. Such funds do not come without duration risk and of course, the possibility that the 1% borrowing rate moves higher over time. The point though is that if a portion of your investment portfolio is directed towards bonds, you might as well benefit from the structurally low and currently negative real interest rates that some bond funds (including PIMCO's) can borrow at.

One last point. Since a home can be an attractive investment in a reflationary environment and since homes are generally financed via a mortgage, a brief comment is in order. First of all, no comment on housing prices in general despite their bubbly appearance. Like politics, most home prices are local so you should know more than I do. If you choose to buy or refinance a home however, I have perhaps a controversial recommendation: avoid the 30-year fixed rate mortgage. Expecting higher interest rates in future years, it seems strange to be arguing for anything other than locking up low rates now. I take the opposite view by recognizing that a 15-year mortgage, which is longer than most homeowner's horizons anyway, comes with yields 50 basis

points or lower than the 30-year alternative. In addition, even shorter term mortgages are so much lower in yield, that they effectively reduce the risk of higher future rates. The way for homeowners to borrow close to 1% is to finance their home via an adjustable rate mortgage geared to the short rate. If you can live with the volatility, you'll have more in the bank over the long term.

No matter what your mortgage or investment preferences, the future years should reflect a recognition of reflationary government policies (primarily U.S.) that seek to transfer wealth from fixed income investors to debt issuers – both government and corporate alike. When too much debt infects the heart of capitalism you either default or inflate it away and the latter is by far the easiest (although not necessarily the wisest) policy. Foreign governments and central banks may be willing buyers of bonds in order to support their own economies and the Fed may be a monopolistic mispricer of credit at negative short-term yields, but that is no reason for the knowledgeable investor to play the same game. Investing in "reflatables" and borrowing with conservatism at the short rate are the two best ways to prosper in such an environment.

Have a wonderful holiday season. Buy some shoes if you must – I understand they are a great feel good/ego substitute. Don't forget to kiss a walrus or two if you get the opportunity. Goo goo g'joob.

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