Bill
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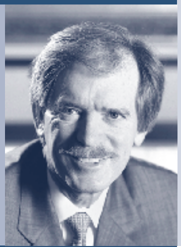

Investment
Outlook

PIMCO

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Fire!

We didn't start the fire
It was always burning
Since the world's been turning

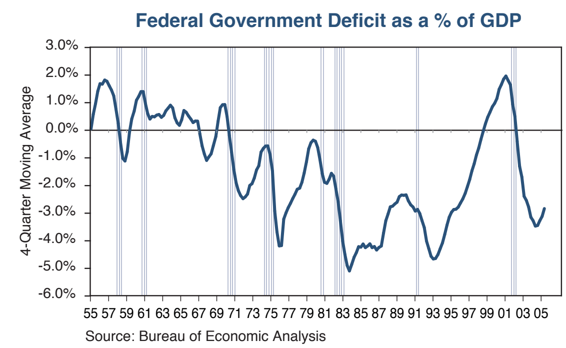
Apologia by Fed Governor
Billy Joel

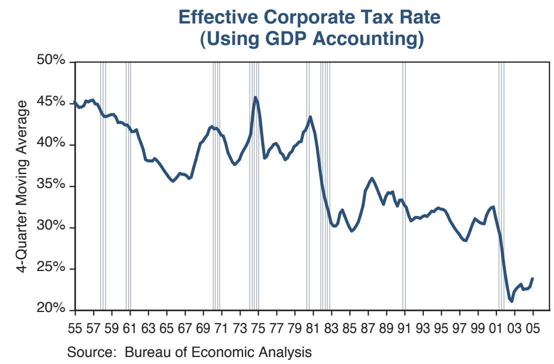
Nero may not be fiddling, but Rome is on fire nonetheless – Rome, Georgia that is: its citizens' homes appreciating at ten percent annually for the past five years; its local newspaper's stock market quotes recovering smartly since October of 2002; its personal and corporate tax rates down sharply; its country's deficit running at 4% of GDP. These are but some of the more visible cans of gasoline stoking economic growth across many American towns and cities these days. This new age Rome is conservatively located far from NYC or LA and theoretically unsingeable by speculative flames of finance center investment exuberance – but it is ablaze nonetheless. Still, ablaze is not quite the same as burning, the latter verb being indicative of decay/destruction whereas the former connotes an intensity/excitement hinting that things can get no better than this. Whether or not chemists would validate this distinction is unimportant. Chemistry is a science, but economics is a dismal science at best and I therefore take license with the supposedly immutable laws of nature to make a point: Rome is on fire and not burning, but in future years it may well be.

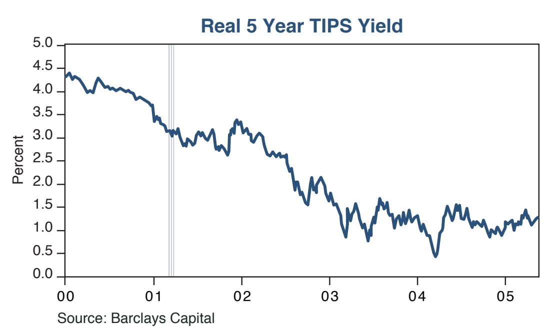
The origins of this fire can be traced as far back as the mid-1980s when we declared victory over accelerating inflation, and a cascade of lower Reaganesque tax rates and Volker/Greenspanesque interest rate cuts were called upon to stimulate a potentially faltering economy. Our most recent matches were struck, however, during the aftermath of the 9/11 recession when it became apparent to policymakers that a combination of American fear/malaise and accelerating globalization might inhibit a normal economic recovery. It was "decided" that in such an environment, asset appreciation –

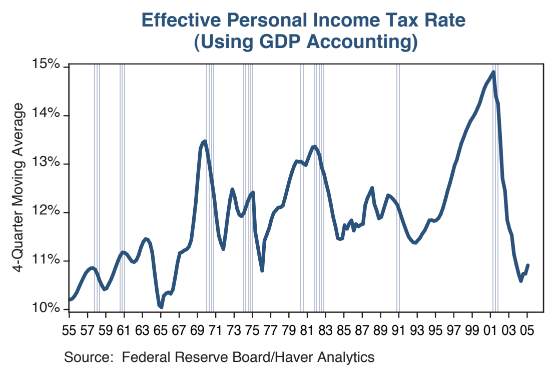
a recovering stock market, and a thriving, "frothy" housing market being the primaries – would be the vehicle of choice to engineer a recovery until domestic investment and concomitant job growth kicked in. To produce that asset appreciation, policymakers came up with logical gasoline cans or "pumps," as I've referred to them in recent *Outlooks*, to start the fire. They are displayed collectively below and their timing and stimulative trend are unmistakably correlated to the most recent U.S. recession in 2001.

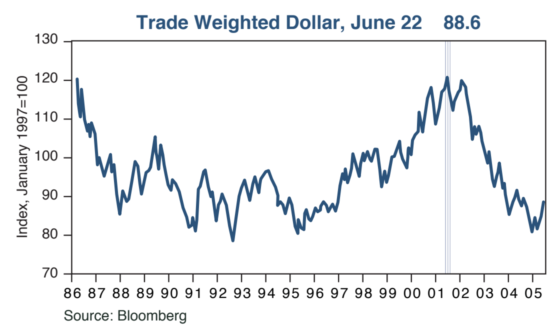
Readers should not revel in any new magical discovery here, however. These asset pumps have been standard recessionary recovery tools since FDR/Keynesian policy innovations in the 1930s, although direct government











spending as opposed to explicit tax cuts were the weapons of choice back then. Still in prior cycles government policy pumps inevitably led to self-sustaining expansions as investment spending, combined with demographic and policy-induced labor force growth, alleviated the need for additional kerosene. In fact, in every previous cycle, the fuel could eventually be restocked by paying down deficits and raising interest rates so that there would be an ample reservoir the next time around.

This recovery is different because it was spawned and subsequently nurtured on the back of asset appreciation alone. Greenspan and company have high hopes that investment and then employment will ultimately kick in and work their self-sustaining magic one more time, but jobs and investment these days go to Asia at the margin, and domestic animal spirits have been squelched by the looming inevitability of reduced returns on risk capital in a low interest rate world. I'll leave the Asian story for another day or let you turn on CNN at 11:00pm EST to get your fill of Lou Dobbs – the Dobbsian spectre of foreign competition on the march is undeniably real. <u>My point in this *Outlook* will be an extension of the thoughts expressed over the past few months that this recovery is on fragile legs because it is asset-appreciation-based and that future asset appreciation is vulnerable based on the weakening stimulative power of interest rates</u>. Therein lies the potential for a white hot speculative blaze turning into a destructive recessionary fire. Such an analogy inevitably suggests that in future years, Rome, Georgia, may not be on fire, but burning.

I begin with the blanket assumption, confirmed in recent speeches by Fed Governor Roger Ferguson and others, that when yields (primarily <u>real</u> yields) fall, asset prices rise. "Because they are <u>interest-sensitive</u>," Ferguson writes, "asset prices are primary components of the channels by which monetary policy is transmitted to the real economy." This logic confirms what is commonsensically known by most Americans – that if real interest rates decline, housing prices and stocks (bonds too!) go up in price.[1]

[1] *Nominal rates may indeed be critical as well in housing appreciation over the short-term – increasing affordability as they decline. But as Robert Shiller has written in his updated book, real housing prices are essentially unchanged for 100 years, and today's real interest rates are back to those witnessed in 1900 as well.*

Greenspan's recent "conundrum" episode is more a reflection of his fear that this process might go too far in housing markets rather than an expression of ignorance as to what's going on. He knows, I think, why interest rates are down, he just doesn't want them to be stoking the housing market so furiously – thus all the "conundrum" talk. But I suggest he should be careful here in raising short rates to produce his desired outcome. Raising short yields beyond 3½% nominal and 1% real risks a recessionary fire. But the fact is that despite raising nominal short rates by 200 basis points, real interest rates are still so low that additional appreciation in houses, stocks, bonds, and other assets may be difficult to engineer. It may be impossible to generate equivalent asset appreciation in future years like we've experienced recently, even if yields begin to fall! We may have reached the point in our asset-based economy, in other words, where the burning of Rome, Georgia, is inevitable, although the timing is uncertain.

Such an observation begins with the assumption that the policy "pumps" graphically displayed on the prior page are approaching their limits. Corporate and personal tax rates are at their nadir in my opinion and politically incapable of further downward progress. While a declining dollar is the one vehicle that can and probably will be used to attempt to keep assets – especially stocks – on an upward path (the dollar's decline in 2003 and 2004 added an estimated 10-15% to S&P 500 corporate profits in each year) the greenback's strength recently is certainly not a help. Most of all though – and here is where my argument succeeds or fails – interest rates that drive the economy cannot go down much further. Since they cannot, the gasoline that they have pumped onto this economy's reflationary fire will be exhausted, assets may stop going up at a double-digit pace, the meager inflation and economic growth they have engendered to date may wither and Rome may begin to burn, not blaze.

Why can't interest rates go down much further? Well, yes there are 300 basis points between current Fed funds and 0, and if the argument depended on that alone then there'd be at least one last pump to use, or one final party for the Fed to hold – a last gasp Bernanke-style infusion of helicopter money. I will admit that another 100 basis point decline in mortgage rates would certainly prolong the current bonfire for a year or so. But it's primarily real interest rates that drive asset prices not nominal rates[2] and real rates for intermediate and longer dated TIPS have limited room on the downside no matter how large the Fed's future fleet of helicopters. For explanatory purposes, I again refer you back to the graph on page 2 which features the downward path of a 5-year TIPS – an appropriate proxy for the main driver of housing prices and stock P/Es, and therefore the primary pump that the Fed has utilized to keep our asset-based recovery underway. Not only have these real yields declined by over 200 basis points in the last several years (with only 135 between here and 0, therefore exhausting much of the Fed's fuel) but there is logic to believe that they can be driven at best back to the 60-70 basis point level experienced in March of 2004 during the winter of America's deflationary fears. That's not much more gasoline, folks. 75 basis points of future stimulation cannot create an asset blaze like the one we've experienced in the last few years.

The following is important, but if your eyes glaze over, skip to the summary.

Why such a meager decline to a 60-70 basis point floor? Well any longer dated, inflation adjusted/inflation sensitive security (TIPS, – and yes – stocks, real estate, collectibles, commodities, gold, etc.) has a limit in terms of how far down its real "yield" can be driven. (Stock yields for instance might be "floored" somewhere in the 2% area where they trade now after adding a risk premium to my TIPS floor estimate of 60 basis points. European stock markets, by comparison, reflective of economies closer to deflation than in the U.S., yield 2.5% on average while their 5-year TIPS yield .75%. Japanese stocks, however yield 1% with a 60 basis point TIPS yield although their market is more insular and inbred. U.S. houses might be "floored" somewhere in the 30-35 times rents zone or a 3% real yield where they trade in many hot markets today.) Granted real short rates can go negative, but for any 5-year+ inflation-adjusting asset, as its "yield" moves closer and closer to 0, the reduced yield reflects

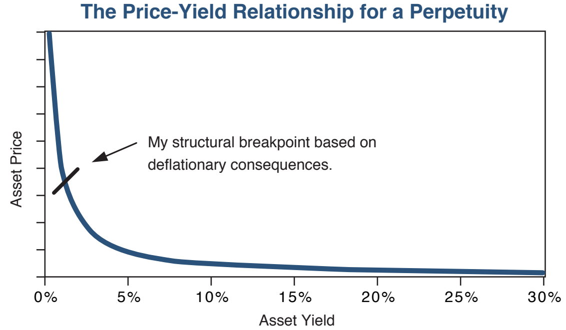
[2] *As inflation moves up or down, its effect on asset prices is theoretically neutralized since the inflationary effect on nominal interest is compensated in the other direction by an opposite influence on future asset cash flows. Thus, real yields are the key to asset multiples and valuation.*

a growing danger that its return will be negative as opposed to positively adjusted if deflation rules the day. If that were to be the case, then the asset's total return would be guaranteed to be negative – an untenable condition for any investor. Recent issues of Japanese TIPS have averaged 75 basis points and never dropped below 40 for longer than a month.

If you're not with me here I apologize, but this is exciting conceptual stuff. Take the 5-year TIPS security for instance. Why would an investor buy this at only a 10 basis point real yield if she felt that deflation might subtract 100 basis points during ensuing years? (Negative inflation or deflation is deducted from almost all outstanding TIPS.) She wouldn't – she would demand a cushion, a 60, 70, 80 or more basis point insurance policy to protect against the even minor possibility of deflation. The same concept applies to stocks and home prices. Deflation subtracts from earnings growth and housing prices just as it does with TIPS returns. Once they have been driven up to values and down to real yields which reflect this 60-70 basis point insurance premium plus an add-on for risk, no logical "investor" would pay more unless profit margins expanded substantially in a deflationary "boom."

Deutsche Bank's George Cooper in a recent research piece labeled "The Burden of Sisyphus" points to the following chart to explain the price-yield relationship of a perpetual asset of which stocks and houses are close relatives. Theoretically, as yields approach 0% the price of a perpetuity approaches infinity but under such circumstances, deflation would almost assuredly be just around the corner and an investor would cease aggressively buying perpetuities (or stocks, houses, etc.) based on the possibility of deflation reducing future cash flows.

The Price-Yield Relationship for a Perpetuity



Source: DB Global Markets Research

In reality then, we may be not that far away from running out of gasoline with 5-year TIPS at 1.3%, stocks at 2%, and houses at 3% real yields. Japan found that out in the 1990s. As real 5-year yields were driven down towards ½%, no investor would aggressively buy stocks or real estate because deflation would subtract from their beginning nest egg at par. It was what Keynes labeled a liquidity trap, one in which animal spirits were dampened not just by overcapacity but by the reality of near 0% real yields and their unacceptable consequences for investors in a deflationary environment.

This is important if only to reemphasize that the limited capacity for real yields to decline from this point removes the largest and most potent pump from policymakers' arsenals. Others such as corporate and personal tax rate reductions seem politically unrealistic. While emotion and irrational exuberance can take asset markets far above "rational" levels of value as NASDAQ 5000 proved, that should not be the odds-on expected outcome for houses or stocks from this point forward.

Summary

Let me summarize my main points:

1) The current rather mild U.S. recovery has been driven by asset appreciation/consumption and not employment or capex growth.

2) Future growth is dependent on additional asset appreciation in real estate and stocks if Asia continues to absorb much of our investment and many of our jobs.

3) Recent asset appreciation has been set ablaze by several fiscal/monetary pumps displayed on page 2 with 5-year real rates being the central driver/gasoline can.

4) Tax cuts are a thing of the past and 5-year TIPS yields can theoretically decline only 60 basis points or so more.

5) The reason why intermediate/long TIPS have an interest rate floor is that if we approach potential deflation, investors risk losing money on a government guaranteed investment. The same concept applies to homes, stocks, and other inflation-adjusting assets without government guarantees.

6) The Fed may soon be out of fuel, despite hints of Bernanke-style helicopter money. Stocks and

houses are already at low yields and high prices reflective of European economies nearing Japan-style liquidity traps.

<u>If the asset pumps run dry and the kerosene cans empty, the inevitable path of the U.S. economy will reflect slow growth at best and recession as a realistic alternative. Inflation then would return to low 1% levels in the ensuing years and be pressing the deflationary crossover line. Nominal Treasury paper would enter the 3-4% zone for 10-year maturities and lower still for shorter intermediates</u>. Such an analysis argues for capturing yield via duration extension <u>now</u> in the face of admittedly artificially low current yields. If Rome burns, long maturity bonds will rule the day and that day may come sooner than many imagine possible.

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Each sector of the bond market entails risk. The guarantee on Treasuries, TIPS and Government Bonds is to the timely repayment of principal and interest, shares of a portfolio that invest in them are not guaranteed.

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