



Getting Traction In Your Vision

President George W. Bush's pop President George H. Bush used to admit that he had a problem with the "vision thing." It bugged the hell out of him that people were always asking about his "vision," as if he was supposed to have a sequel to President Ronald Reagan's vision of *Morning In America*. Poppy Bush never could figure out why he needed a new vision to run the country. What was required, he thought, was simply to implement Mr. Reagan's vision in a "kinder, gentler" way. As it turned out, of course, fate was not kind and gentle to Mr. Bush, the last of the generation that won WW II to serve in the Oval Office.

Despite winning the Gulf War, America turned him out, not because he didn't have vision, but because Americans' vision of boundless prosperity had lost "traction." America experienced a recession, and Mr. Bush didn't get traction in fighting it.

And that, for the average American, was the one unforgivable Presidential sin. When the economic stuff hits the oscillator, the President is supposed to unplug it. And even if he fails, he must show traction in trying. 'Cause, you see, the new American mantra ain't vision, it's traction.

Gotta show traction in your grip as you grab for the gusto. President Clinton understood that. He was a man of traction, with vision defined by whatever showed adhesive properties. Such as the notion of cutting the budget deficit. Clinton never had such a vision. But Fed Chairman Greenspan did, telling Mr. Clinton from the start that a lower deficit would make the Fed mellow and the bond market happy. And since Mr. Clinton found traction in a mellow Greenspan and a happy bond market, he found vision in cutting the budget deficit. Vision was the outcome of traction, not the other way 'round.

Equity Valuation Is At Best Fair And Corporate Bonds Are Still Cheap

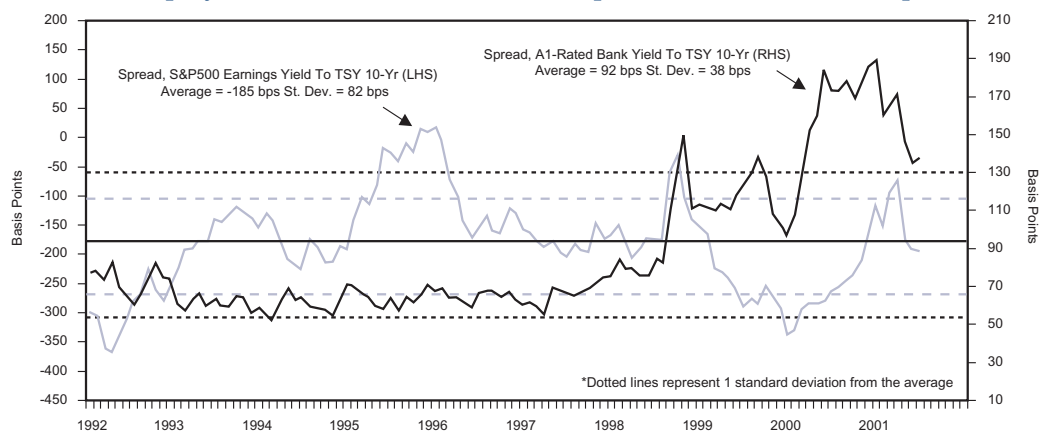


Figure 1

Source: Bloomberg

So, too, with America's policy of a strong Dollar. Clinton never started with a vision of a strong Dollar being in "the best interest of America." In fact, Mr. Clinton's first Secretary of the Treasury, Mr. Lloyd Bensten, categorically didn't believe in a strong Dollar, particularly against the Yen. Mr. Bensten's first foray into the land of currencies, less than a month into office in 1993, was to declare that he wanted a weaker Dollar versus the Yen, so as to get traction in trade negotiations with Japan. Mr. Clinton thought that was pretty cool, 'cause a rising Yen did seem to thoroughly annoy the Japanese and delight Detroit, so he bought Mr. Bentsen's traction as his vision, and blessed it.

Until, of course, his next Secretary of the Treasury Robert Rubin decided in early 1995 that a "strong" Dollar would be in the best interest of the nation, since it would make foreign investors want to invest here. This seemed to be a right good thing to Mr. Clinton, coming on the heels of the nastiest bond market in history in 1994, triggered by a Greenspan gone very unmellow. Getting traction in trade negotiations with Japan no longer really mattered, since Japan was proving to be a greased dance floor, but traction with foreign investors did matter, so as to re-incite mellow feelings in the bond market. So, Clinton got a new grip on his vision, and changed his vision.

Clinton was good, it must be said. Very good. Rather than being constrained by the "vision thing," Clinton practiced serial monogamy with the "traction thing," packaging it as vision. And it worked. In contrast, Vice President Gore couldn't get any traction in his vision, and didn't know how to fake it.

Consequently, the man lost his shot at filling Clinton's shoes, despite running with the lowest Misery Index (inflation plus unemployment rate) in a generation.

The man deserved to lose. Which, of course, meant that George W. Bush had to be the winner, regardless of whether he deserved to win or not. But to his credit, Dubya understood the need for a vision: take Reagan's conservatism and make it kinder and gentler, and voila, you get "compassionate conservatism." Nobody knows what the hell it means¹, which makes it an even better vision!

Easy Credit On Happy Hour Prices

As long as it can get traction, of course. 'Cause without traction, vision is but an epiphany dancing on Kris Kristoferson's fault line of freedom. Which brings us to the matter of the right here and right now: The economic stuff is again hitting the oscillator, and the nation expects its policymakers to unplug it. Fed Chairman Greenspan is the anointed man in charge, and he is clearly a man of vision, still seeing a New Economy in burgeoning bloom, as he testified before Congress last week:

By all of the measures, by all of the evaluations that we make, we are only partway through a major technological expansion, which has elevated the underlying growth of structural productivity – meaning the trend growth in productivity over periods of years. In the context of that, the long-term expected rate of return has risen, as has the long-term expected rate of growth of earnings.

That automatically induces a re-evaluation of what the equity values in the economy are. Whenever you get into that sort of process, there is always the danger, and it seems to happen more often than not, that if there are real underlying forces to raise equity values because of structural productivity advances which have occurred, there is a tendency to overdo it.

In other words, as I have said previously, in many of the technological areas, we've seen demand doubling for certain newer technologies every year, but the supply goes up three or four times a year. And so what happens is you get a glut, huge retrenchment; but it doesn't undercut the fact that that demand was essentially there, and it may be slowed down because of the supply-shock effect.

But it doesn't change the longer-term structural possibilities for higher earnings, higher rates of return, and higher productivity. And in that regard, I see nothing in what has been going on in the most recent period to alter the view that when we are through this period, and it's been a very traumatic adjustment process, we will go back to a rate of increase which is significantly above where we were in the two decades prior to 1995.

We will not go back to some of the – you know, 50 percent increases in capacity, which is what occurred last year in the high-tech area; at least I hope not – but we will have solid expansion in those areas to complete this technological set – the synergies of a very significant number

of technologies. And we have not completed them yet; they still have a significant way to go."

That, friends, is vision. Greenspan's got it. He concedes, without really saying so, that there was irrational exuberance on the supply side of the technology coin. But, he also argues there wouldn't have been such merriment, if there hadn't been something real on the demand side, something of an underlying positive fundamental nature. He concedes, without really saying so, that there was irrational exuberance in equity market valuation. But, he also argues that such frivolity would not have been possible, but for the very same positive shock in technology.

Yes, he acknowledges, the capitalist process is prone to drinking too many beers. But the very same capitalist process is also the creative source of beer that both tastes better and is less filling, boosting structural productivity growth. And that's a very good thing. Therefore, Mr. Greenspan sees his current mission as getting cyclical demand side traction in his secular supply side vision, by stimulating heavy drinking of surplus beer.

And he's trying, he stresses. What's more, he will be successful, he confidently predicts, defying charges that monetary policy easing has somehow lost traction:

"With respect to the notion of the ineffectiveness of Fed policy, I think it's important to understand that when you evaluate monetary policy, which we tend to do by disaggregating its impact in

short-term rates, long-term rates, the exchange rate and a few other different variables, we never quite, even after we add up all of our evaluations of those so-called channels of monetary policy effect, replicate the broader correlations that exist between monetary policy and economic growth, in effect implying that we don't fully capture all of the various different channels which impact on the economy because of movements in the short-term Federal Funds rate.

The article² to which you (Senator Sarbanes) refer, which is, I thought, a thoughtful article, lines up these individual items, and if indeed that was all that was involved in the process, then I would say that we would be concerned about what the impact of monetary policy is.

But if you look back historically, that does not explain the full impact. And I'm not saying that there is a black box, or anything of that nature, but the complexity of our economy is such, and the way liquidity flows through the system is such that you essentially get very complex differences in the way monetary policy plays out. But at the end of the day, it does seem to be effective."

Essentially, Mr. Greenspan said, "shut up and drink." And, he observed, Americans not living on Wall Street seemed to be doing precisely that, not in technology, but in extracting equity from their appreciating homes:

"...one of the things that's occurring in this country is the evolution of housing

into a very sophisticated, complex industry, in the sense that we not only have got the standard home building aspect of homeownership-related activities, but we're also beginning to find that as homeownership rises and as the market value of homes continues to rise, even in a period when stock prices are falling, we're observing a rather remarkable employment of that so-called home equity wealth in all sorts of household decisions.

Indeed, it seems to us that the rise in the value of homes – which, if anything, has accelerated during this period of rapid decline in stock prices – has created a very substantial buffer of unrealized capital gains, which are being drawn upon through the home equity markets, through cash-outs, through the turnover of existing homes, which has been quite substantial despite the weakness in the economy.

If unrealized capital gains were declining, which is, of course, what happens when you extract equity from homes, yes, it would be a problem. But there is no evidence of that. Indeed, despite the fact of the significant extraction of home equity gains, the level of unrealized capital gains in homes continues to rise apace. So it's not a depleting asset, if I may put it that way. It could be, but fortunately it is not."

"Fortunately, it is not." Those were the magic words: Greenspan has put his PUT beneath housing's wings.

Home prices shall not, from an economy wide perspective, go down. To the contrary, they shall go up, so as to ensure that unrealized capital gains in homes are not depleted by homeowners' extraction of unrealized capital gains. The margin debt that matters is not that on stocks, but on homes. And there will be no margin calls on homes, by god and by Greenspan. There will be no calls from mortgage brokers to homeowners seeking cash, only calls begging homeowners to take cash. This is America, don't you know.

Okay, I exaggerate; but only a bit. We're talking about getting traction here, and getting traction is an exciting thing. Or least it had better be somewhere beside capital investment, or the economy is headed straight down the plughole. Mr. Greenspan may wax wishfully for the secular day of more energized exploitation of synergistic opportunities through technology for productivity and profits. But, there ain't going to be any cyclical traction in that vision as long as the world has the stuff coming out the wazoo. And he may have vision of equities being permanently valued on a higher plane than prior to 1995, on the basis of rational exuberance. But, there ain't gonna be any cyclical traction in that vision until irrational exuberance has been extracted from prevailing equity valuations.

Thus, monetary policy ease is all about getting, maintaining and turbo-charging traction in household spending, fueled by rising prices for the pillar of the American Dream, the home. Or, as I said last month³:

"There is room for the Fed to create a bubble in housing prices, if necessary, to sustain American hedonism. And I

think the Fed has the will to do so, even though political correctness would demand Mr. Greenspan deny any such thing (just like he denied belatedly attacking the NASDAQ bubble)."

I rest my case. Mr. Greenspan's secular vision of a New Economy will be underwritten with the cyclical traction of a bubble in the oldest of the Old Economy's stalwarts, the roof over your head. Get long or be wrong. Except, of course, if your home is located in certain geographic bastions of the New Economy, in which case you can cry or sell, or both.

A Trip Down M&M Lane

"Okay," you say, "I already own a house in the right place and might buy a second one. But what about the implications for financial assets? What's the right mix of stocks and bonds for my investment portfolio?"

Since PIMCO is a bond house, you no doubt fully expect me to tout bonds. I won't disappoint. But actually, I don't want to focus on stocks versus government bonds, the traditional axe of asset allocators. Main Street business does not finance itself at the risk-free interest rate. Rather, it finances itself at a risk premium to the risk-free rate: the equity risk premium in the case of equity finance, and the credit risk premium in the case of debt finance. So, to me, the critical issue in asset allocation for the years ahead is **the relative valuation of the equity risk premium and the credit risk premium**, and where those two risk premiums should logically go.

To figure that out, we need to take an excursion into corporate finance theory. Sorry

about that, but I just don't know any other way to get traction in that analytical domain. Conceptually, as all MBAs learned from Modigliani and Miller (M&M), in world of efficient capital markets with no taxes, a company's value is a function of the inherent earnings powers of its assets, not its capital structure, or mix of bond and equity issuance. We also learned that in a world of taxes, which most certainly do exist, it makes sense for companies to lever their balance sheets, effectively ramping the after-tax return on equity at taxpayers' expense.

But too much of a good thing is a bad thing, M&M also taught us. A company should lever only to the extent that the tax benefit of having Uncle Sam as a neutered equity partner exceeds the cost of a rising credit risk premium associated with increasing leverage. Simply put, M&M said that leverage is good, up until that point at which the credit market starts pricing your sorry backside for default.

M&M won a Nobel Prize for that concept, which became the M&M theorem. And rightly so. In fact, back when I learned the theorem in graduate school over twenty years ago, it perplexed me why so many companies bragged about their high credit ratings, if what M&M said was true. Little did I know the world was on the cusp of not just learning, but getting traction with the M&M theorem, helped along by a certain fellow in Beverly Hills named Mike Milken.

A very practical man, Mike said the right amount of leverage was indeed that which took a company to the cusp of default risk, and built a business to find out where that cusp might be. To wit, he put traction in

M&M's vision. Mike ultimately spun out of control, of course, taking his own firm into default. But Mike's essential vision was grounded on a simple and correct foundation: the M&M theorem was and is right. Companies can be under-levered, not just over-levered.

And indeed, corporate finance in the post-Milken 1990s remained essentially grounded in the M&M theorem, but with an important new twist, notably after 1995, Greenspan's dating of the magical secular turning point to more robust structural productivity growth. Remember, as he said again this week, quoted back a couple pages, such a development lifts "long-term expected rates of return," and therefore, "automatically induces a revaluation of the equity values in the economy." Assuming that indeed did happen, the M&M theorem demanded that managements of America's firms do something, to make sure that magical increase in equity values did, in fact, accrue to their shareholders!

And what to do? Apply more leverage, logically and rationally, M&M would argue. To wit, if the inherent earnings power of a firm's assets has undergone a positive shock, the firm is worth more. And, without a re-jiggering of its capital structure, the firm will be paying too much in taxes, because it will be under exploiting its borrowing power.

Thus, by M&M, a positive structural productivity shock should (1) raise the market value of a firm's equity versus its book value; and (2) induce the firm's management to (a) invest hand over fist (remember Tobin's Q!), and (b) simultaneously lever the daylights out of the firm on a book value basis.

One of the easiest ways to do the latter is simply to issue debt to buy back shares. Indeed, again by M&M, managements should do that “trade” until the credit market cries uncle, declaring via a soaring credit risk premium that the firm is about to cross the divide from screwing Uncle Sam out of taxes to screwing itself with default risk.

So, managements of America companies did, as shown in Figure 2. And then oops, they did it again, as is the wont of the human condition, as both Mr. Greenspan and Britney Spears regularly remind us. Entrepreneurs, given a good idea, do have “a tendency to overdo it,” in Mr. Greenspan’s words. When managements of America’s “great companies,” as Treasury Secretary O’Neil likes to call them, get traction in their vision, nothing succeeds like excess. And in a world of the M&M Theorem, excess is defined as over-estimating the value of a firm’s earning assets and/or over-leveraging those assets.

Pulling Back From The Cusp

Excess is precisely what America’s irrationally exuberant companies did in the late 1990s, facilitated by America’s similarly irrationally exuberant investors. The best evidence that mutual journey into bubble hood was a plummeting equity risk premium and a soaring credit risk premium, as shown in Figure 1 on the cover. With that valuation bubble having blown up, both companies and investors are now rehabilitating their risk appetites.

In particular, companies are doing precisely what the M&M theorem suggests: if the fundamental value of a firm’s assets falls (perhaps because it was irrationally esti-

As Market Value of Equity Evaporates Relative To Book, Management Must Reduce Debt Relative to Book

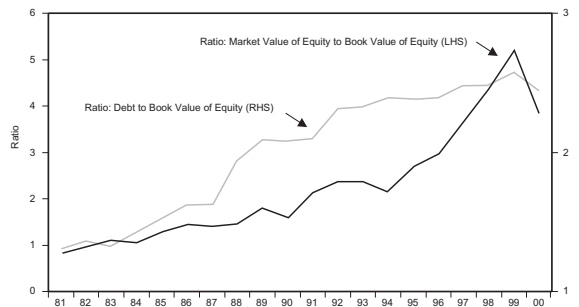


Figure 2

Source: Factset, Steve Kim at Credit Suisse First Boston

mated in the first instance!), hammering its market value relative to its book value, managements should (a) curtail investment (again, remember Tobin’s Q!), and (b) reduce debt relative to book value, so as to reduce the credit risk premium. Both of these things are going on in spades right now: America’s businesses are slashing both capital budgets and equity buybacks, the hallmarks of the Double Bubble age, as displayed in Figure 3.

Thus, I’m fundamentally bullish on American business, as is Mr. Greenspan and Mr. O’Neil. Good businesses with bad balance sheets are fixing their balance sheets, and bad businesses with bad balance sheets are going out of business. This is the way that capitalism is supposed to work. Unlike Mr. Greenspan, however, I see no reason whatsoever to anticipate a return to robust business investment any time soon. To expect such a thing after a bubble is to put out the landing lights for Amelia Earhart. She may return, but I see no reason to bet it that way. Bubbles do not re-bubble for a very, very long time after they blow up.

But that does not mean that the American economy is a fundamentally bad business,

After Double Bubbles In Investment And Share Buybacks, Corporate Managers Are Finally Sobering Up

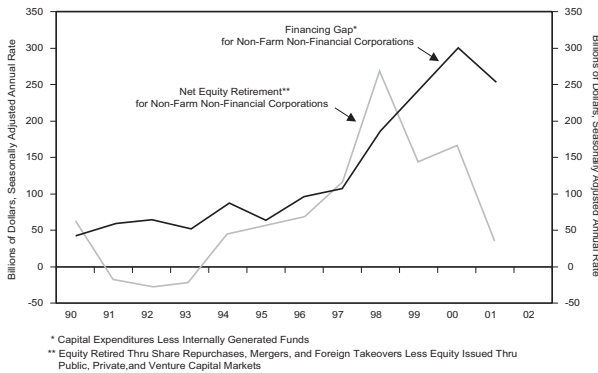


Figure 3

Source: Federal Reserve Flow of Funds

just that it must change, with a shifting of resources away from business investment to household investment and consumption. And a housing bubble fits the bill. So I'm not critical of Mr. Greenspan at all for helping to inflate one, despite bellyaching about mal-investment from members of the Austrian School of economics (there must be a lot of you, gauging from the volume of email I get accusing me of intellectual or moral bankruptcy, or both!). Better a bellyache than an empty belly, I say.

Policy making in a capitalistic system is, in the end, about ensuring traction in private sector visions of making a bundle. Booms and busts go with the territory. Keynesian capitalists, a group which Mr. Greenspan has joined, even if he'd never admit it, know that the key to maintaining animal-spirited traction is to lubricate the action, wherever it may be, with easy credit.

And what about that matter of allocating your portfolio between stocks and bonds? Very simple: Keep re-allocating your corpo-

rate equity exposure into funds that hold government-guaranteed (directly or indirectly) mortgages and good ole fashioned (high-quality!) corporate bonds. Greenspan has put his PUT beneath the former, and corporate America is rehabilitating the latter.

And that, friends, is a nice combination for getting traction in your vision of steady wealth accumulation!

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¹ The topic of the very first Fed Focus, "Principled Populism", Fed Focus, September 7, 1999.

http://www.pimco.com/bonds_commentary_fed_focus_0999.htm

² "The Federal Reserve Finds The Limits Of Its Power," New York Times, June 25, 2001

³ "Show A Little Passion, Baby" Fed Focus, June 29, 2001

http://www.pimco.com/bonds_commentary_fed_focus_0701.htm

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