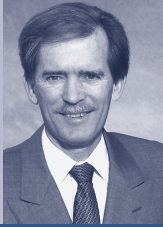


Bill  
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# Investment Outlook

P I M C O

January 2002

## The Scouting Party

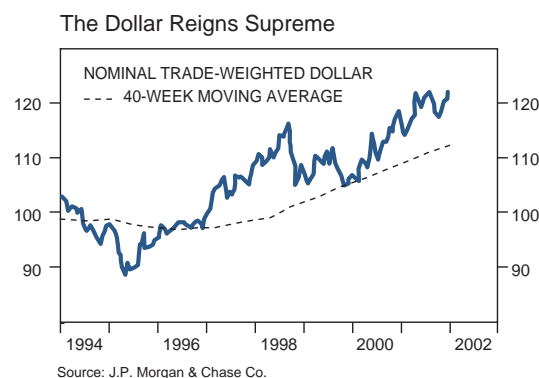
January 1<sup>st</sup> is my favorite day of the year. For most people it's their birthday, but that day to me is less of a celebration than a reminder of advancing age and shadows lurking in some distant future. Wedding anniversary? Close, but not quite the big cigar. New Years takes the cake because it's my day of ultimate relaxation. No more parties for one thing, but better yet, the bond market is closed. It shuts down 52 weekends every year, of course, but this day is special because the prior year's performance, like Prince Albert, is sealed in a can and the starting gun for next year's race hasn't gone off yet. Ah, blessed peace. And so it was this morning, January 1<sup>st</sup>, 2002, that I picked up the local newspaper in relaxed, yet gleeful, anticipation of comparing PIMCO's performance numbers to those of our struggling competitors, when lo and behold, I came upon a column from Jonathan Lansner, the *Orange County Register's* astute financial editor, suggesting that PIMCO "resolve to stop predicting what the stock market may do. Isn't being the world's greatest bond gurus enough acclaim?" he asked. I knew he meant me, of course—not that PIMCO doesn't have lots of gurus—we just don't have lots of gurus that write about the stock market. I knew too, that he had a point. Being a student of history and all, there

was Hannibal, the Romans, Napoleon and the twentieth century Germans to point to as examples of empire builders whose reach exceeded their grasp. Stick to your knitting in other words, was Lansner's admonition and it was a good one.

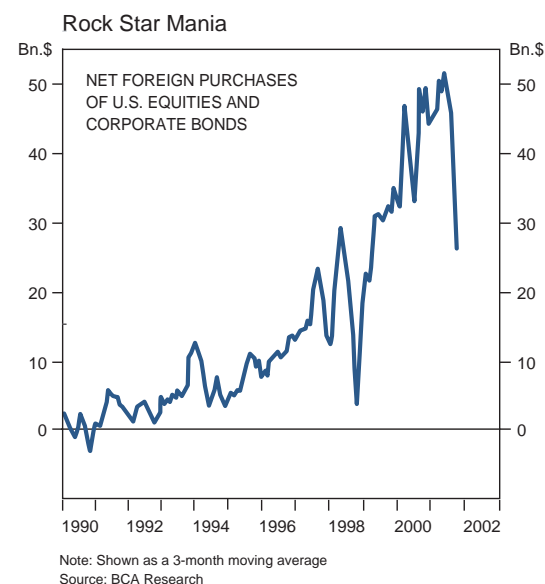
Still, there is a difference between the sending of armies to conquer foreign territory, and sending scouts to find out if yours is about to be invaded. I aspire not to manage stocks, although as I've told reporters in the past, in my next life, if I'm not singing in a rock band, I'll betcha I probably could be a pretty good one. My fascination with stocks, though, is twofold. First of all, *Outlook* readers, both big and small, can benefit from the other side of the story. Stock market hope has turned into stock market hype over the past decade and readers should know the potential downside, as well as the up. Secondly—and this is where the scouting party concept comes in—the movement of stocks, much like the Huns or the Goths or whoever they were that came streaming down into Northern Italy a few centuries ago, can threaten bond prices. I want to think about where stocks are going so that I can better defend my own portfolios. Bubbles, crashes, and everything in between—including the wealth effect,

401(k) allocations, and actuarial assumptions of future equity returns—are going to affect the bond market. I want to think about stocks for all these reasons and more and, as any columnist knows, writing means thinking. Like an execution a fortnight hence, an *Outlook* focuses my mind more than anything else. So stand by dear reader for future missives on the good ol' stock market. But honest, Jonathan, no territorial ambitions here. I'm just sending out the scouts.

In a similar vein, on this heretofore relaxed January morning, I take pencil to paper (no laptop for this kid) to contemplate the fortunes of the U.S. dollar, and if you think writing about the fortunes of the stock market is tricky, try getting your arms around currencies. But let me be basic here, if only because I don't know much more than the basics. A strong dollar is good for U.S. bonds because it keeps inflation low and promotes foreign demand for our securities. Overseas investors want bonds that not only pay a high rate of interest but, are denominated in a currency that goes up, not down. So, a strong dollar is bond positive and the two trends sort of reinforce each other as seen in the following charts.



Since the mid-1990s, the trade-weighted dollar has appreciated nearly 35 percent and foreigners have scooped up hundreds of billions of dollars of corporate and Treasury bonds in response. Put another way, foreigners have scooped up hundreds of billions of dollars of corporate and Treasury bonds and the dollar has appreciated nearly 35 percent in response. There is a chicken and egg here, but it is not always easy to know which comes first. What is fairly certain is that the U.S. has been the star performer in the global economy over those same years and because it was, it attracted a huge amount of capital from overseas that helped support our bond markets and keep interest rates lower than they otherwise would have been. So a strong dollar is bond friendly, both from the standpoint of lower import prices and inflation, as well as the adoring fans it creates among foreign investors. Sort of like rock star groupies, I suppose—just touching anything issued in the U.S. these past few years was enough to satisfy.



Can it keep on keeping on? Well now, there is the rub and the conundrum. The answer lies substantially in the future economic growth rates of the U.S. versus the rest of the world. Groupies can turn on you quickly if the hits don't keep coming, so it pays to either keep turning out the platinum CDs or, at least, create the illusion that there is one being made in the studio. That, the U.S. has done, and apparently continues to do. Despite the bursting of the tech bubble, rock bottom short-term interest rates, and the onset of recession far sooner than in Europe or parts of Asia, the dollar has stayed strong. Most economists share the judgment that while Europe's long-term growth rate should be 2.5 percent a year or so, that of the U.S. will be closer to 3.5 percent. So while the American economy hasn't produced a hit CD for nearly twelve months, investors believe there is one in the studio that's about to be released and that it will go platinum faster than those of Europe, Japan or almost any other rock star nation.

Superstar status creates its own set of problems, however, that ultimately turns the magic bus in the opposite direction. An appreciating dollar may be good for securities markets but it wreaks havoc on manufacturers who compete in the global marketplace. It is not without some justification that Jerry Jasinowski, President of The National Association of Manufacturers, has led a recent charge in support of a reversal of the "strong dollar" policy of the current and recent Administrations which began with Robert Rubin in the early '90s. The combined market share of General Motors, Ford and Chrysler, for instance, will probably shrink to 63.2 percent for all of 2001 from 71.4 percent

in 1997. That 8 percent loss speaks to higher unemployment, lower profits and, yes, slower economic growth—the same growth that investors are counting on to justify a higher level for the U.S. dollar. Prior to Robert Rubin, Secretaries of the U.S. Treasury conducted economic policy with an eye towards promoting the competitiveness of American industry, as well as services such as banking, insurance, and financial management. For the past eight years or so, the focus has been on the markets (stock and bond) as opposed to the marketplace. That a significant amount of hollowing out (to use a 1970's and 80's phrase) has occurred is indisputable.

Now, in the midst of a global recession, our "strong dollar" policy may be just what the doctor ordered for our competitors to revive faster than the good ol' U.S. of A. Not only has Japan gotten the message that a weaker currency is better but, Asia as a block may soon pile on the devaluation band wagon as a way to survive and ultimately thrive in this era of slim pickens. "Competitive devals" were tried in the 1930s and went under the name of "beggar thy neighbor" policies. That they cannot work collectively is indisputable, except for the monetary stimulation that usually accompanies them. Selectively, however, it is possible to beggar your neighbor and we are being beggared right and left these days. When the Swiss Central Bank proclaims that it no longer wants the Swiss Franc to be viewed as a safe haven currency, you know the world is turning topsy-turvy.

The fate of the dollar rests not just on the relative expensiveness of our goods and services, however, but on the

perception and ultimate reality of our ability to innovate and produce new products more efficiently. Economists call that productivity; Greenspan calls it the New Age Economy, and investors continue to share in the belief that in the U.S. we do it better. I have my doubts as readers know from prior *Outlooks*, especially that of June 2001, labeled "The Weakest Link." If, indeed, we are more productive and remain so, then foreign capital could continue to keep pouring in, supporting the existing level of the dollar as well as our record \$400 billion current account deficit. If, as I believe we are not, then the magic bus may shift to reverse, taking the dollar with it, as well as U.S. stock and long-term bond markets.

That the strength of the dollar depends, in part, on our status as the world's military superpower and global policeman is just one additional factor to consider going forward. Our success or failure in the War Against Terror will be watched by foreign investors to measure whether the U.S. is truly a safe haven or whether it is as vulnerable as the rest of the world in future years. But the War on Terror notwithstanding, it seems likely to me that the dollar is in the process of peaking and that it can no longer be counted on to positively influence inflation downward, nor to lure foreign investors to our shores in search of a can't miss currency and securities market double play. If so, there are numerous investment strategies that take their cue from such a reversal. The forever canonized long Euro versus short dollar trade that PIMCO, as well as countless other financial institutions, have deployed for what seems like centuries is one of them. With European short rates well above those of the U.S., at least true believers are being paid to wait these days. Secondly, though, if the dollar does lose its luster, look for the

U.S. bond market yield curve to be affected. With the short end of the curve being held down by the Fed for much of 2002, foreign investor aversion to financing the current account deficit will most likely be felt via a buyers' strike or even sale of the longer end of the curve. Repatriation, whether it's simply to avoid a potentially weak dollar versus the Euro or, perhaps, to shore up a bankrupt economy as in Japan, is an increasing possibility and could most easily affect 10-30 year maturities as opposed to 1-3 year paper. PIMCO hopes to be ahead of the pack if, in fact, events begin to unfold in this direction. And Mr. Lansner, if you will permit, a weaker dollar is certainly no friend of stock market investors either.

Whatever takes place, there is no doubt in my mind that despite the beginning of a mild recovery in the U.S. economy in early 2002, that it's a dangerous world out there, both militarily and financially. Lots of imbalances exist, from consumer and business balance sheets, to imploding economies such as those of Argentina and Japan, to overvalued currencies such as the U.S. dollar. There are likely more bubbles to go pop—the secret is in knowing when, and which ones have enough air to stay afloat. The dollar may not explode but it has got a leak with an almost indistinguishable hiss that should grow louder as 2002 winds on. Best to keep one ear close to the dollar bubble and the other one listening for the return of an altogether different scouting party. Those sentries may have additional reports that could lead to bond market profits. For now, it is time to turn on the Fiesta Bowl and to relax for the rest of this most wonderful of all days. Happy New Year!

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