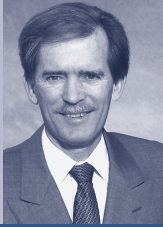


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Investment Outlook

P I M C O

February 2002

"Kennethed"

*Behind Every Great Fortune
There is a Crime*

Honore de Balzac
1799-1850

Piling on Enron these days is all the rage so I thought I might as well give it a try. There's not much there to be loved except the company's innocent employees and finding them seems harder than ferreting out Osama Bin Laden from an Afghan cave. Enron has rather quickly morphed from the paragon of capitalistic virtue into the whipping boy for its seamy side. An article in the *Wall Street Journal* several weeks ago spoke to how certain nouns or pronouns in the English language were being turned into intransitive verbs - as in "you've been NASDAQed" - to indicate a sudden plunge in personal fortune. After that article I had thought that being "ENRONed" might find its way into your Funk & Wagnalls just as easily but this *Outlook* brought to my cerebral cortex an even better prospect which plays off of the name of its now infamous chairman Kenneth Lay. And if you think that being "Kennethed" is a little too awkward for the American public, you have only to use your imagination to conjure up the better alternative.

This search for the perfect description of modern day capitalism brought to mind a quote from another era by noted author Honore de Balzac. It has bothered me for years because, if leapfrogged from the 19th to the 21st century, it is indeed a

scathing indictment of any and indeed all of us who aspire to the aggrandizement of wealth. Discriminating between a great/small fortune or even a healthy 401k does one little good according to Balzac's definition: it becomes only a question of the size of the crime. Balzac, however, lived in a pre-capitalistic age where wealth was created very slowly if at all. There were no Robert Fultons, Henry Fords, or Sam Waltons to point to who legitimately increased the welfare of the planet via new ideas that ultimately enhanced productivity and therefore GDP. But to Balzac, if you were rich you were a thief, either through the actual taking, or via inheritance which when followed far enough back in time, was a stolen good as well.

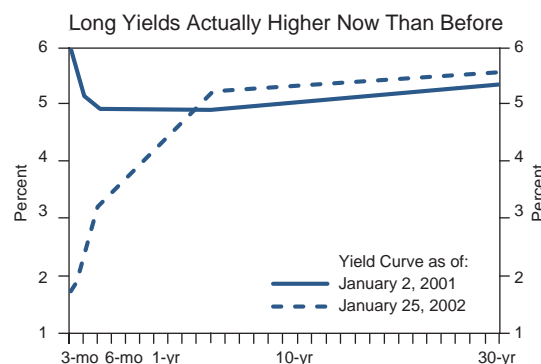
As Walton's Wal-Mart proves, though, not all capitalists can be classified as criminals and thank goodness for that, but some of them clearly can be and that is what bothers me at the moment. If the 1990s go down as one of the gilded ages of capitalism, then surely we have turned the corner, or better yet, begun to change the color of how we look at our captains of 21st century industry. Instead of being green with envy, our fickle chameleon-like public opinion is slowly turning into a raging capillary bursting red. We're discovering that we've been

"Kennethed" all right, but not just by ENRON. Arthur Andersen LLP, Henry Blodgett and Blodgett-like clones, as well as much of Wall Street and points west have participated in the implicit bilking of the American public. Sure there's a sucker born every minute and you can fool some of the people all of the time, but there are laws and regulations to minimize the tomfoolery. That the accounting profession had only internally enforced rules, and was perhaps internally conflicted in providing both accounting and consulting services for the same client was perhaps the foremost of today's Balzacian transgressions. And if not a crime, then the industry's near unanimous acceptance of "pro-forma" earnings was certainly a travesty. Those things are about to change. Instead of "deregulation," the operative word for the upcoming decade will be "reregulation." Much like the American public's apparent willingness to exchange a piece of personal freedom for increased safety from terrorist attacks, they now seem inclined to trade a portion of deregulation's upside for the prophylactic comfort of not being "Kennethed" one more time. The mood is turning nasty and there will be more than Kenneth Lay's blood on the streets before it is over and done with.

There are those who suggest that Alan Greenspan's head as well will eventually join others in the basket at the bottom of American public opinion's mercurial scaffold, but I am not one of them. While I dispute his insistence on New Age productivity miracles, and while I believe there are limits to the "Greenspan put" and his ability to save the economy just "one more time," every

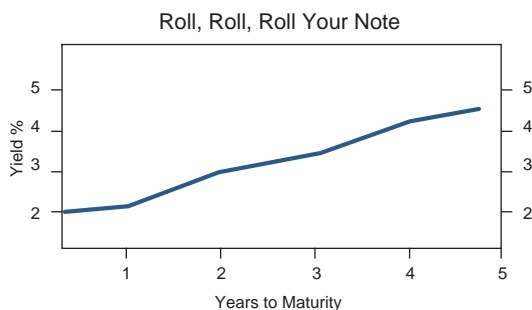
time, the man has fostered prosperity for most of his 15 years in office. That he has had to use up most of the tricks in his magical monetary bag to steady our economic boat is more our fault than his. We as a public spend too much money, not too little, as President Bush suggests, and it has been that way for nearly 40 years. The jig is about up whether it be the irrational expectations for stock market appreciation, the near 0% consumer savings rate, or the unwarranted level of the dollar vs. Europe's new Euro. The American capitalistic model is about to come under attack and as Pogo might put it, the problem is not Greenspan, "the problem is us." Sooner or later the rest of the world - which are the true lenders of last resort - will balk, as will the domestic PIMCOs and the game will be over. The question is not really if, but when.

One early sign of things to come and the increasing frustration that must now be Alan Greenspan's, lies in the shape and indeed the level of the U.S. yield curve. We all know of course that short-term rates are rock bottom low, but less well observed is that throughout the entire journey from 6¹/₂% to 1³/₄% Fed funds, long-term yields and perhaps more importantly home mortgage rates remained relatively unchanged as seen in the following chart.



While lower short rates no doubt serve to lubricate the economy near term, it's the longer portion of the curve and especially the 15- and 30-year fixed rate mortgage rate that provides the gas that makes the American economic engine go. Those haven't moved and analysts and perhaps Alan Greenspan himself must be wondering why. Is not inflation coming down and should not this ultimate driver of interest rates be forcing down longer yields as well? Granted, the U.S. Federal surplus is turning to deficit and the Japanese economic sink hole may be pointing to some repatriation of long-term investments, but surely the 1 to 1½% inflation that lies ahead in 2002 should be having some effect on lower mortgage rates and long-term yields.

Not so, and not likely either. The answer, in addition to the above qualifications, rests in a tricky phenomenon known as "rolling down the yield curve." Here's why.



The simplest example comes from using the example of a two-year Treasury Note yielding 3%. To the unsophisticated eye, the "return" on this piece of paper seems undoubtedly and indubitably to be 3%. It will be if held for the two-year maturity. But what if the hedge or intelligent bond investor sells that two-year note

after one year with one year to go until maturity? At that time (as long as Alan Greenspan keeps short-term rates low) the investor will hold a one-year Treasury Note which yields 2%, not 3% because that is today's existing yield. The investor's original two-year Treasury Note with a 3% fixed coupon will then be priced in the market at 101 not 100. In other words, in addition to the 3% current yield our "roll down investor" has earned a 1% capital gain for a total of 4% for the first year. Now granted, 4% is still not a great return when compared to a 5½% long-term Treasury bond or a 6½% mortgage, but you can take this "roll down" principle and apply it to five-year Treasuries or better yet five-year swaps and theoretically approximate those 6%+ yields and more with less risk because of their shorter durations.

I introduce this well-known phenomenon not to confuse you or to suggest you have to have a brilliant yet mottled mind like that of John Nash in order to understand Greenspan's frustration, but the phenomenon is quite significant. How about this for a rather simplified conclusion: The lower Greenspan takes short rates and the longer he promises to keep them there, the harder it will be for mortgage rates and long-term yields to come down. PIMCO-like investors and the hedgies will avoid or even sell the long end, for the comfort of rolling down the intermediate portion of the curve. This year's disinflationary trend will shrink to the background as a primary influence.

And so? And so? Well, the interesting conundrum of all this - if true - is that the current predicament may resemble the

nightmarish philosophy of our Vietnam experience in which we thought it was necessary to destroy the country in order to save it. While that turned out to ultimately be untrue, the parallel today is that Greenspan may have to threaten to raise short-term rates in order to lower mortgage and long-term yields. Only then will "yield curve rollers" desert the security of the roll down for the greater risk and reward of the longer end of the curve. Will he do it in the next six months? Will he not only threaten but follow through with hikes in an Alice in Wonderland attempt to lower long yields, mortgage rates and therefore reenergize the recovering but still wobbly U.S. economy? I doubt it. If he did, it would indeed (at least to me) be a masterstroke that culminated a 15-year + career as Fed Chairman, a stroke that would begin to eliminate the excessive amount of financial leverage that hedge funds, GSEs, and others now impart to the U.S. financial balance sheet, and that would give the U.S. economy a fighting chance to live well if not extravagantly. We've passed the possibility of living high off the hog but a nourishing hot dog has still a decent chance of being digested if long-term rates and mortgage yields can come down. But by keeping rates low and suggesting they will not rise until the U.S. economy is back on its feet, Greenspan may be guaranteeing just the opposite. For if long-term mortgage rates do not come down then refinancing or "refis" will soon cease to be a factor in bolstering U.S. consumer income. And if long-term corporate borrowing rates do not come down then investment will continue to languish.

The trick for the long-term health of the economy is to lower 10-to 30-year yields, not Fed Funds - and that Greenspan has failed to do. Best to go the other way and mimic the more conservative behavior of the European Central Bank. I do not believe he will do that in the next six months, and so you can count on PIMCO to continue to be in the camp of the "roll-downers." But he should, and if he does, PIMCO would quickly help to reinforce the perverse logic outlined in the preceding pages by buying long bonds. Am I daring Mr. Greenspan? Sure, I guess so. Because behind this next move lies the fortune of the American economy and investors alike. Should he misstep, it would not come close to a modern day version of a Balzacian faux pas, but it might surely rank at the top of future historian's lists of missed opportunities and downright shames.

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